2495

No. 11,718

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION (a national banking association), *Appellant,*	
vs.	
UNITED STATES OF AMERICA, *Appellee.*	

APPELLANT'S OPENING BRIEF.

GEORGE H. KOSTER,
300 Montgomery Street, San Francisco, California,
Counsel for Appellant.

FILED
MAR 12 1948
PAUL P. O'BRIEN, CLERK

PERNAU-WALSH PRINTING CO., SAN FRANCISCO

Subject Index

Table of Authorities Cited

Cases

Statutes

Miscellaneous

No. 11,718

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

Bank of America National Trust and Savings Association (a national banking association),

Appellant,

vs.

United States of America,

Appellee.

APPELLANT'S OPENING BRIEF.

JURISDICTIONAL STATEMENT.

This is an appeal from a judgment of the District Court of the United States for the Northern District of California, Southern Division. The opinion of the Court below is reported at 69 F. Supp. 932 and is set forth in the record herein (R. 106).

Appellant is a national banking association organized and existing under and by virtue of the laws of the United States of America. Its principal place of business is in the City and County of San Francisco, State of California, and in the Northern District of California, Southern Division (R. 2, ¶ II; R. 38, Stip. ¶ 2).

The action arises under the Internal Revenue laws of the United States and is for the recovery of income taxes assessed against and collected from the Appellant for the years 1938 and 1939 by the Appellee through its agent, Clifford C. Anglim, the then Collector of Internal Revenue for the First Collection District of California who was no longer in office as collector of Internal Revenue at the time this action was commenced (R. 2, 3, ¶ I, III; R. 38, Stip. ¶ 1, 3). After the payment of said taxes the appellant duly filed written claim for refund thereof as provided by law and said claim was rejected by the Appellee through its agent, the Commissioner of Internal Revenue, on April 4, 1944 (R. 11, ¶ XIV; R. 39, Stip. ¶ 4).

This action was commenced in the District Court on November 25, 1944 (R. 140). It was brought pursuant to the provisions of Section 24 (Twentieth) of the Judicial Code, U.S.C., 1940 Ed. Title 28, Section 41(20) (R. 2, ¶ I; R. 38, Stip. ¶ 1).

The matter came on for trial before the District Court and the judgment of that Court was entered March 14, 1947 (R. 142). On June 9, 1947, under authority of Section 128 of the Judicial Code, U.S.C. Title 28, Sections 225 and 226, appeal was taken to this Court to review the judgment of the Court below (R. 132). On July 14, 1947 the Court below, upon motion duly made, extended the time for filing the record on appeal to September 6, 1947 (R. 139). This appeal and the transcript of record were filed and docketed in this Court on August 29, 1947.

STATEMENT OF THE CASE.

(a) Nature of the case.

This case involves the income tax liability of the appellant for the years 1938 and 1939. The appellant is claiming a larger deduction for depreciation on buildings, furniture and fixtures than was allowed by the Commissioner of Internal Revenue. It was conceded in the Court below that the appellant was entitled to a larger deduction for depreciation on buildings (R. 58, Stip. ¶ 27; R. 115, ¶ 8) and judgment was entered accordingly. The Court below concluded, however, that the appellant was not entitled to any greater depreciation on furniture and fixtures than was allowed by the Commissioner of Internal Revenue and rejected appellant's claim therefor. This appeal is from the said judgment which, though granting appellant some recovery denied appellant's claim for the balance of the recovery sought in this action.

The method employed by the Commissioner of Internal Revenue in computing the annual depreciation deduction was to take the cost of the property as of December 31, 1935,[1] reduce it by depreciation deducted on the original income tax returns for years prior thereto to determine the unexhausted basis of the property, and to spread that unexhausted basis over the estimated remaining years of useful life of the property (R. 42, Stip. ¶ 9; R. 56, Stip. ¶ 22f).

---

[1]In the settlement of tax controversies for the years 1936 and 1937 the parties hereto reached an agreement as to the amount of depreciation to be allowed as a deduction for those years (R. 44, Stip. ¶ 10), so the matter of the depreciation accumulation for those two years is not in controversy and is not material to the adjudication of the issue in this proceeding.

The primary question in this case is whether in computing the unexhausted basis for depreciation as of December 31, 1935 of the buildings, furniture and fixtures owned by the appellant, the cost of said property should be reduced by *excessive* depreciation taken as deductions by appellant on its original income tax returns for the years 1932 to 1935, or by the *correct* depreciation for those years. The answer to this question depends upon whether under the facts and the law, the excessive depreciation was "allowed" within the meaning of that term as used in Section 113(b)-(1)(B) of the Internal Revenue Code (which by virtue of the provisions of Section 114(a) prescribes the basis for depreciation as well as the basis for gain or loss) which provides as follows:

> "Section 113(b) The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.
>
> (1) General Rule.—Proper adjustment in respect of the property shall in all cases be made—
>
> (B) In respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws * * *"

All of the facts in this case were stipulated as hereinafter explained in the "Facts" subsection of this brief (infra, p. 17). The District Court incorpo-

rated by reference as part of its Findings of Fact, the matters set forth in these stipulations (R. 114, ¶ 2).

Prior to January 1, 1932 the annual depreciation computed by the appellant bank for income tax purposes was exactly the same as the depreciation computed for bookkeeping purposes (R. 119, ¶ 20; R. 48, Stip. ¶ 16). In 1930 and 1931 the Bank reported large net losses on its tax returns and deducted substantial amounts on those returns for depreciation (R. 44, Stip. ¶ 12). However, there is nothing to indicate that the depreciation deducted in those years was not considered fair and reasonable on the basis of the conditions and facts known at that time, although on the basis of facts subsequently developed the depreciation was excessive. The Bank acknowledges and has acknowledged throughout this proceeding, that the *allowable* depreciation is the depreciation computed on the facts known at the time the deduction is taken and so has made no claim in this proceeding that there should be any restoration to the basis of its property, of any depreciation deducted in the years 1930 and 1931 even though no tax benefit was obtained from those deductions. (*Commissioner v. Mutual Fertilizer Co.* (C.C.A.-5, 1947), 159 F. (2d) 470; *Cleveland Adolph Mayer Realty Corp.* (C.C.A.-6, 1947), 160 F. (2d) 1012).

In 1931 and 1932 the Bank inspected and surveyed all of its properties and made a revised estimate of the condition of those properties and of their useful lives; and on the basis of that estimate it determined that the depreciation schedules then being used were in-

correct, and it compiled a new schedule for the computation of the depreciation, and commencing January 1, 1932, this new schedule was used for determining the depreciation which was written off on the books of the Bank for the years 1932 to 1939 inclusive (R. 119, ¶ 20; R. 57, Stip. ¶ 25); *and it is stipulated in effect that the depreciation on furniture and fixtures computed under this schedule for the years 1932 to 1935 was the correct depreciation allowable as a deduction under the applicable income tax statutes in those years* (R. 126, ¶ 35; R. 58, Stip. ¶ 26a), and the depreciation on banking premises computed under this schedule was actually a bit less than the amount allowable for the years 1932 to 1935 (R. 58, Stip. ¶ 26b).

The Tax Department of the Bank in preparing the income tax returns for the years 1932 to 1937 inclusive ignored the revised depreciation schedule for various practical reasons stated in the stipulation in this case (R. 60, Stip. ¶ 31, 32), and continued to report as the depreciation deduction the depreciation computed on the schedule used by the Bank prior to 1932 (R. 119, ¶ 20) though fully cognizant that the depreciation deduction so computed was incorrect (R. 62, Stip. ¶ 31c). The official of the Bank responsible for the Bank's income tax return did not know that this practice was being followed until 1938 (R. 67, Stip. ¶ 33). In 1938 and 1939, the tax years involved in this proceeding, the practice of continuing the obsolete and incorrect depreciation schedules was stopped (R. 62, Stip. ¶ 31(d) (e)) and the income tax returns for those

years reflect as deductions the depreciation as computed under the said correct schedule being used by the Bank for bookkeeping purposes (R. 119, ¶ 20; R. 63, Stip ¶ 31e).

The Bank had net losses for income tax purposes for each of the years 1932 to 1935 inclusive in excess of the entire amount of depreciation deducted in the respective year, so obtained no tax benefit whatever from the depreciation deduction or any part of it (R. 120, ¶ 21a; R. 44, Stip. ¶ 12, 13). Since the depreciation deducted each year (approximately 170% of book (correct) depreciation) was substantially in excess of the depreciation taken on the Bank's books, the excess had to be and was disclosed on a reconciliation schedule on the tax return for each of those years (R. 124, ¶ 29; R. 60, Stip. ¶ 30), so the Commissioner was on notice that there was this substantial difference between the depreciation deducted in each of those years and the depreciation charged off by the Bank on its books in those respective years (R. 60, Stip. ¶ 30).

In February 1937 an Internal Revenue Agent, a duly authorized representative of the Commissioner of Internal Revenue, commenced an audit of the Bank's 1935 income tax return; the Bank called his attention to the fact that the depreciation deducted on the return was excessive and requested him to cooperate with it in the preparation of correct depreciation schedules; the Agent recognized the error but in the course of his audit concluded that there would not be sufficient adjustment, including the depreciation ad-

justment, to result in a tax liability for the year; and he thereupon refused to prepare or aid in the preparation of a revised depreciation schedule because, under established Bureau of Internal Revenue procedure, he was not allowed to compile or aid in the compilation of revised depreciation schedules where any adjustment which might result therefrom would not result in a tax liability (R. 121, ¶ 21(c); R. 50, Stip. ¶ 19).

In accordance with Bureau procedure (R. 122, ¶ 22), after the Agent progressed far enough in his audit to be satisfied that there would not be sufficient corrections to result in a tax liability, he so reported to his superiors who transmitted his report and the tax return to the Bureau of Internal Revenue (R. 30, Stip. ¶ 6). This was true as to the audit of all years 1932 to 1935 (R. 120, ¶ 21b; R. 33, Stip. ¶ 16 to 21). The Bureau, upon receipt of the case, reviewed it, approved it, and sent it to the closed filed (R. 121, ¶ 21d). The Bank was not furnished with a copy of the Agent's report (R. 30, Stip. ¶ 6).

The same thing happened in January 1938, when another Internal Revenue Agent audited the Bank's 1936 income tax return (R. 122, ¶ 24; R. 51, Stip. ¶ 20). Subsequently in 1939, after the 1936 return had been accepted by the Bureau of Internal Revenue, it was reaudited by the Internal Revenue Agent's office and adjustments were proposed which did result in a tax liability for that year (R. 122, ¶ 25: R. 52, Stip. ¶ 21). The additional taxes proposed as the result of this reaudit were contested and finally settled by

stipulation (R. 35, Stip. ¶ 22; R. 44, Stip. ¶ 10). No specific authorization from the Commissioner of Internal Revenue for this reaudit or redetermination of tax liability was secured (R. 35, Stip. ¶ 22), nor was it required since it came within the extensive general delegation of authority by the Commissioner of Internal Revenue to his field agents (R. 31, Stip. ¶ 7; R. 33, Stip. ¶ 15). In the course of this reaudit and the concurrent audit of the returns for the years 1937, 1938 and 1939, the matter of the revision of the depreciation schedules and the correction of the depreciation deduction was given careful attention by the Internal Revenue Agents and the Bank (R. 53, Stip. ¶ 22; R. 35, Stip. ¶ 22, 23) and revised depreciation schedules were prepared (R. 144, Ex. 3 at R. 151 to 192; and Ex. 16, R. 273 and 274, which are but two of 80 schedules as stipulated, R. 294).

The preparation of these revised depreciation schedules for approximately 500 buildings and the furniture and fixtures contained therein was a tremendous job extending from December 1939 to November 1941; and under the direction of Internal Revenue Agents the Bank employed an independent appraisal and engineering company to report upon factors required for use in the schedule, and employed a special staff of men to work on the compilation of the schedule (R. 53, Stip. ¶ 22). The record shows that it was because of the full appreciation of the intricate nature of this job, that the Bank's tax department employees and representatives did not undertake the revision of the schedules until they could have the opportunity to do

so in conjunction with the cooperation of the Government agents (R. 63, Stip. 31e; R. 66, Stip. ¶ 32g).

The revised schedules were so constructed that the remaining cost of the property (cost less depreciation) as of December 31, 1935, was first computed, and the annual depreciation thereon was the prorata of that remaining cost spread over the estimated remaining useful life of the property; and in the resultant revised schedules the Bank's consistent contention that the depreciation was wrong ever since January 1, 1932 and should be corrected in determining the correct remaining cost as of December 31, 1935, was recognized and the remaining cost as of December 31, 1935 was computed by deducting from the cost only the correct (or allowable) depreciation for the years 1932 to 1935 (R. 124, ¶ 32; R. 54, Stip. ¶ 22(b) (c) (d)). The revised schedules were mutually acceptable to the Bank and the Internal Revenue Agents (R. 36, Stip. ¶ 23; R. 54, Stip. ¶ 22b).

When the revised depreciation schedules were referred to the Commissioner of Internal Revenue (Bureau of Internal Revenue, Washington, D. C.) in November 1941, the Bureau rejected them on the ground that the tax returns for the years 1932 to 1935 had been "accepted" and therefore the depreciation deducted thereon was "allowed" and had to be deducted from the cost of the property to determine the basis for depreciation regardless of whether the depreciation deducted on the return was right or wrong and regardless of whether the Bureau knew that the deduction was wrong (R. 125, ¶ 32; R. 36, Stip.

¶ 23, 24). The revised schedules were thereupon discarded by the Bureau and the depreciation was recomputed on the basis of cost as of December 31, 1935 reduced by the excessive depreciation deducted on the tax returns for 1932 to 1935 (R. 125, ¶ 32; R. 56, Stip. ¶ 22f; R. 193). The remaining cost as computed by the Bureau on furniture and fixtures was approximately $1,400,000 less than was computed in the revised depreciation schedule and on banking premises was approximately $600,000 less than was computed in the revised depreciation schedule (R. 118, ¶ 19; R. 183), so the Bureau action in effect wiped out approximately $2,000,000 of capital investment which on the basis of the revised depreciation schedules which had been prepared by the Bank and the Revenue Agents would have been returned to the Bank through depreciation deductions in years following 1935.

The record shows that on December 10, 1941 (before the case of the Virginian Hotel Corporation of Lynchburg hereinafter discussed started on its course of litigation) the taxpayer presented in writing to the Commissioner of Internal Revenue a statement of the facts as herein presented and urged the acceptance of the revised schedules (R. 275) and from then until 1945 representatives of the Bank held a number of conferences with the representatives of the Bureau in an effort to secure acceptance of the schedules (R. 66, Stip. ¶ 32h). Although the Bank had at all times been considering the filing of amended returns for 1932 to 1935 its representatives felt confident that mutually acceptable depreciation schedules could be worked out

and that the filing of amended returns would thus be rendered unnecessary (R. 66, Stip. ¶ 32h). However, when in 1945 the Bureau of Internal Revenue finally concluded conferences with the Bank's representatives by refusing to accept the revised depreciation schedules even though acknowledging that those schedules reflected the correct depreciation for the years 1932 to 1935, the Bank filed amended returns for the years 1932 to 1935 reporting thereon the correct deduction for depreciation for the respective years as reflected in the said revised depreciation schedules (R. 67, Stip. ¶ 32i). The correction of the depreciation did not overcome the net losses for those years so the amended returns showed no tax liability (R. 232, 239, 260, 266). The Government was not deprived of any tax by reason of the correction.

The Bureau of Internal Revenue refused to consider the amended returns for any purpose up to the time the stipulation filed in this proceeding were signed (R. 127, ¶ 39; R. 37, Stip. ¶ 25). However, after this case was submitted to the District Court the Bank received a letter from the Internal Revenue Agent in Charge advising it that the Amended returns for 1932 and 1933 were accepted as correct; and Appellant Bank filed a motion in the District Court to reopen the case to receive this letter in evidence and the Government opposed the motion by contending that the examination and acceptance of the amended return was all a mistake (R. 69-105). The Court denied the motion and that action is assigned as one of the errors in this appeal (R. 113, 138, ¶ 10; R. 291).

The Court below sustained the Commissioner's action in reducing the property cost by the excessive depreciation taken in the years 1932 to 1935, concluding that *"disclosure of the excessive depreciation claimed and disallowance of its deduction by revenue agents or by the Commissioner does not authorize the latter to rectify the taxpayer's mistake or error of judgment. I am unable to perceive any basis for a different conclusion in this case from that enunciated in the Virginian Hotel Corporation case."* (R. 112).

It is appellant's position that because of the difference in facts, the Virginian Hotel Corporation decision has but limited application to this case; that whether or not that decision is applicable, the above quoted conclusion of the Court below is not a correct interpretation or application of that decision; and, that under the facts and under the law, in determining the basis for depreciation as of December 31, 1935 the cost of the property should not have been reduced for depreciation for the years 1932 to 1935 inclusive, by any greater amount than the stipulated correct depreciation for those years which was charged off on the books of the Bank, accepted by the Government agents in their compilation of depreciation schedules, and reported on the amended returns for those years.

(b) Issues presented.

A. The ultimate issue involved is the determination of the basis for computing depreciation on furniture and fixtures and the amount of depreciation

thereon to which plaintiff is entitled as a deduction in computing its taxable net income for the years 1938 and 1939; and more particularly, this issue involves the following questions of law:

(1) Whether the Commissioner or Internal Revenue, in computing the basis for depreciation on banking premises and on furniture and fixtures, acted properly and legally in reducing the cost of said property by excessive depreciation taken in error by plaintiff as a deduction on its original income tax returns for the years 1932 to 1935 inclusive, where

(a) Plaintiff called the Commissioner's attention to these errors and finally corrected them by the filing of amended returns to report the correct deduction for depreciation for those years, and

(b) Prior to the filing of the amended returns, plaintiff in collaboration with the agents of the Commissioner of Internal Revenue in work which extended over a period of almost two years had compiled a corrected depreciation schedule for all years reflecting the correct deductions for the years 1932 to 1935, which corrected schedule was mutually acceptable to the plaintiff and to the agents of the Commissioner of Internal Revenue, but was rejected by the Commissioner on the ground that the cost had to be reduced by the excessive deductions taken on the original returns for the years 1932 to 1935 inclusive because he had "accepted" the original returns for those years and had thereby "allowed" the depreciation taken as a deduction thereon within the meaning of

Section 113(b)(1)(B) of the Internal Revenue Code and such allowance was conclusive regardless of whether the amount "allowed" was right or wrong.

(2) Whether under the particular facts of this case the Commissioner of Internal Revenue did "allow" the depreciation taken on the original return for 1932 to 1935 inclusive, within the meaning of the term "allowed" as used in Section 113 (b)(1)(B) of the Internal Revenue Code, where

(a) he was on notice, first constructive and then actual, that the depreciation deducted was erroneous, and

(b) he had challenged the tax returns and the deductions taken thereon by sending the returns to his field agents for examination and audit, and

(c) his agents had challenged the depreciation deductions and deferred the correction thereof until it could be done, and actually was done by them, in conjunction with an audit of a later year tax return involving a tax liability;

and if he did "allow" the original deduction when he "accepted" the original returns, whether that allowance, under the circumstances in this case, was legal, effective, and conclusive.

(3) Whether under the particular facts of this case, the Commissioner of Internal Revenue should have considered and given effect to the amended re-

turns filed by plaintiff for the years 1932 to 1935 inclusive, where

(a) the plaintiff had already called the Commissioner's attention to errors in the depreciation deduction, and

(b) the amended returns reflected the admittedly correct depreciation deduction for those respective years, and incorporated the information which the Commissioner's Agents had considered when they examined the original returns for 1935 and 1936 and when they compiled their report correcting the depreciation deduction for the years 1932 to 1935.

(4) Whether the consideration and acceptance of those amended returns by the agents of the Commissioner of Internal Revenue after this proceeding was submitted to the District Court for decision (the evidence with respect to which the District Court Judge refused to hear by his action in denying plaintiff's motion to set aside the Order for submission and to reopen the case to hear such evidence) constitutes an allowance of the correct depreciation deductions which were taken on those amended returns.

B. A further issue in this case is whether the District Court erred in denying plaintiff's motion to reopen the case and to hear evidence as to the consideration and acceptance of the amended returns for the years 1932 to 1935 inclusive by the Agents of the Commissioner of Internal Revenue after the stipulation of facts in the case had been filed with the Court.

(c) Facts.

The facts were agreed upon and are admitted by the pleadings or stipulated in the written stipulations of facts which were filed with the Court below and adopted by said Court as part of its findings of fact (R. 114 ¶ 2).

In its Findings of Facts the Court also gave a lengthy summary of the stipulated facts (R. 114 to 127). In the foregoing statement herein of the "nature of the case" there is presented the salient features of the case upon which the appellant's position and argument will be premised. Where further detailed facts are important to the propositions presented reference will be made thereto in the argument but in the interest of brevity and succinct presentation, we are taking the liberty of submitting at this point merely a reference to the stipulated facts and a short summary explaining the stipulations and their contents in lieu of including herein the lengthy and detailed stipulated facts which are set forth in full in the Transcript of Record in the proceeding (R. 28-68 and Exhibits R. 144 to 290).

The Stipulation of Facts was submitted in two parts identified as Stipulation No. 1 (R. 28) and Stipulation No. 2 (R. 38) and as a part of the latter there were submitted 17 exhibits referred to therein. Although all the exhibits were brought up to this Court, certain portions not considered essential to the consideration of the issues were omitted from the printed record (R. 144-290; Stip. R. 292-294).

Stipulation No. 1 is devoted primarily to a statement of the procedure followed by the offices of the Commissioner of Internal Revenue in the handling and audit of a tax return; of the extensive delegations of authority to the field agents under the decentralization method for audit of returns; of the practice followed in the audit of returns showing net losses; of the practice of reopening closed returns; of certain procedure followed in the audit of Appellant's original tax returns for the years 1932 to 1936 inclusive; of the action of the Bureau of Internal Revenue rejecting the revised depreciation schedule prepard by its own agents and the Appellant; and of the Bureau refusal up to that time to consider the amended returns filed by Appellant for the years 1932 to 1935 inclusive.

Stipulation No. 2 contains a statement of the jurisdictional facts such as the filing of the returns, payment of the tax, filing of the refund claims, rejection of the claims, etc.; of the depreciation deductions reported on the respective returns for the years 1930 to 1939 inclusive and the adjustments made thereto by the Commissioner for the years years 1938 and 1939; of the method employed by Appellant in computing the depreciation for accounting purposes prior to 1932, and for 1932 and subsequent years; of the mistake in the reporting of the depreciation on the original tax returns for the years 1932 to 1935 inclusive and reasons therefor and the efforts made by Appellant to correct this mistake; of the audit of the returns and the action taken by the Agents following

the prescribed procedure as outlined in Stipulation No. 1; of the challenge of the depreciation deduction by the Revenue Agents; of the extensive work and expense involved in the compilation of the revised depreciation schedule by the Revenue Agents and the Appellant (Exhibit 16 to the stipulation (R. 273-274) containing two of 80 similar schedules (R. 293) is a copy of those schedules on buildings alone, and Exhibit 3 (R. 151 to 196) contains the Engineer Revenue Agent's report of his work and the problems involved in the preparation of the revised schedules); of the fact that the depreciation taken by Appellant on its books was the correct and allowable depreciation for the years 1932 to 1935 inclusive and the revised depreciation schedules reflect that depreciation as the correct depreciation; and of the fact that Appellant filed amended returns for the years 1932 to 1935 reporting thereon the correct depreciation allowable for those years.

As explained in the statement herein of the "nature of the case" although the Commissioner had not considered the amended tax returns for any purpose up to the time the stipulations were signed, after the case was submitted to the Court the Appellant received a letter from the Internal Revenue Agent in Charge advising it that its amended returns for 1932 and 1933 had been examined and accepted as correct. After receipt of this letter the plaintiff (Appellant herein) filed a motion with the District Court to reopen the case to accept this letter in evidence. The defendant filed objection thereto contending that the examina-

income as determined by the Commissioner, the plaintiff, on March 17, 1942, overpaid its income and excess-profits taxes and deficiency interest paid thereon to the defendant as follows:

Year	Tax	Deficiency Interest	Total Overpayment
1938	$ 8,264.57	$1,475.48	$ 9,760.05
1939	5,112.00	603.73	5,715.73
	$13,396.57	$2,079.21	$15,475.78

and plaintiff is entitled to recover a judgment against the defendant for the aggregate sum of $15,475.78, together with interest thereon to be computed from and after the date of payment thereof (March 17, 1942), as provided by Section 177 (b) of the Judicial Code, as amended by Section 808 of the Revenue Act of 1936 (28 U.S.C. 1940 ed. Sec. 284).

STATUTE AND REGULATIONS INVOLVED.

STATUTE:

Internal Revenue Code:

Section 23—In computing net income there shall be allowed as deductions:

(1) *Depreciation*—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescense)—

(1) of property used in the trade or business, * * *

Section 114(a) Base for Depreciation.—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property

shall be the adjusted basis provided in Section 113(b) for the purpose of determining gain upon the sale or other disposition of such property.

Section 113(a) Basis (Unadjusted) of Property. —The basis of property shall be the cost of such property; * * *

Section 113 (b) The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) General Rule.—Proper adjustment in respect of the property shall in all cases be made—

(B) In respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws * * *

REGULATIONS:

Treasury Department Regulations 101 relating to the Income tax under the Revenue Act of 1938.

Art. 23 (1)-1. Depreciation.—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income.

Art. 23 (1)-5. Method of Computing Depreciation Allowance.—

The capital sum to be recovered shall be charged over the useful life of the property, either in

equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made. If the cost or other basis of the property has been recovered through depreciation or other allowances no further deduction for depreciation shall be allowed. The deduction for depreciation in respect of any depreciable property for any taxable year shall be limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis. The burden of proof will rest upon the taxpayer to sustain the deduction claimed.

A taxpayer is not permitted under the law to take advantage in later years of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years.

Art. 23 (1)-9. Records of Depreciable Property.—In order that the verification of depreciation allowances claimed by the taxpayer may be facilitated, depreciation shall be recorded on the taxpayer's books, the amount measuring a reasonable allowance for depreciation either being deducted directly from the book value of the assets or preferably being credited to a depreciation reserve

account, which should be reflected in the annual balance sheet. For the same reason the allowance shall be computed and recorded with express reference to specific items, units, or groups of property, each item or unit being considered separately or specifically included in a group with others to which the same factors apply. Also, the taxpayer's books shall show the basis of the depreciable property and any adjustments thereto, and, in cases where the basis of the property is other than cost, or value on March 1, 1913, or value at date of acquisition (as, for example, if the property was acquired by gift or transfer in trust after December 31, 1920), or through a reorganization of a tax-free exchange (see particularly section 113 (a)), the books shall show the data used in ascertaining such basis and the adjustments thereto. If a taxpayer does not desire to have his regular books of account show all of the factors entering into the computation of depreciation allowances, such factors shall be recorded in permanent auxiliary records which shall be kept with and reconciled with the regular books of accounts.

Art. 114-1. Basis for Allowance of Depreciation and Depletion.—

The basis upon which exhaustion, wear and tear, obsolescence, and depletion will be allowed in respect of any property is the same as is provided in section 113-(a), adjusted as provided in section 113-(b), for the purpose of determining the gain from the sale or other disposition of such property, except as provided in article 23 (m)-3, relating to depletion based on discovery value, in

article 23 (m)-4, relating to percentage depletion in the case of oil and gas wells, and in article 23 (m)-5, relating to percentage depletion in the case of coal mines, metal mines, and sulphur mines or deposits.

Art. 113(b)-1. The cost or other basis must also be decreased by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion to the extent such deductions have in respect of any period since February 28, 1913, been allowed (but such decrease shall not be less than the amount of deductions allowable) under the Revenue Act of 1938 or prior income tax laws. The adjustment required for any taxable year or period is the amount allowed or the amount allowable for such year or period under the law applicable thereto, whichever is the greater amount. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. The determination of the amount properly allowable shall, however, be made on the basis of facts reasonably known to exist at the end of such year or period. The aggregate sum of the greater of such annual amounts is the amount by which the cost or other basis of the property shall be adjusted. For example, the case of Corporation A discloses the following facts as of January 1, 1938:

Year	Allowed	Allowable	Allowed, but not less than amount allowable
1931	$6,000	$5,000	$6,000
1932	7,000	6,500	7,000
1933	6,500	6,500	6,500
1934	6,500	6,000	6,500
1935	5,000	6,000	6,000
1936	4,500	6,000	6,000
1937	4,000	6,000	6,000
	$39,500	$42,000	$44,000

The depreciation allowed but not less than the amount allowable in this example as of January 1, 1938, is $44,000, and the cost or other basis of the property is to be adjusted by that amount.

SPECIFICATION OF ERRORS.

The appellant relies upon the following errors committed by the District Court (R. 136-138).

1. The District Court erred in deciding that appellant is entitled to a deduction for the years 1938 and 1939 for depreciation of furniture and fixtures only as allowed by the Commissioner of Internal Revenue in the amount of $380,762.15 and $419,718.48 respectively, instead of the higher amount claimed by appellant in its complaint in this proceeding.

2. The District Court erred in its conclusion of law sustaining the Commissioner of Internal Revenue in reducing appellant's cost of its furniture and fixtures by admittedly excessive depreciation for the years 1932 to 1935 inclusive, to determine the basis for computing the depreciation deduction for later years.

3. The District Court erred in deciding as a matter of law that the Commissioner "allowed" the depreciation deducted by the appellant on its original return for the years 1932-1935, within the meaning of the term "allowed" as used in Section 113(b)(1)(B) of the Internal Revenue Code.

4. The District Court erred in deciding as a matter of law that "disclosure of the excessive depreciation claimed and disallowance of its deduction by revenue agents or by the Commissioner does not authorize the latter to rectify the taxpayer's mistake or error of judgment".

5. The District Court erred in deciding as a matter of law that there is no basis for a different conclusion in this case than the conclusion reached by the U. S. Supreme Court in the case of *Virginian Hotel Corporation of Lynchburg v. Helvering,* 319 U. S. 523.

6. The District Court erred in *failing to decide* as a matter of law—

(a) that the Commissioner of Internal Revenue was bound to accept the determination of his agents as to the correct depreciation allowance for the years 1932 to 1935, and

(b) that the Commissioner of Internal Revenue could not reject the determination and allowance made by his agents, and could not in lieu thereof make a determination "allowing" a depreciation deduction for those years not authorized by the income tax statutes applicable to those years.

7. The District Court erred in failing to conclude that under the circumstances of the case the Commissioner had no authority to allow a depreciation deduction for the years 1932 to 1935 in excess of the amount allowable under the income tax statutes applicable to those years.

8. The District Court erred in failing to decide as a matter of law that the correct basis for depreciation of furniture and fixtures as of December 31, 1935 is the cost of said furniture and fixtures reduced by the stipulated correct depreciation allowable for the years 1932 to 1935 rather than the cost reduced by the erroneous depreciation deducted on the original income tax returns for those years.

9. The District Court erred in failing to decide as a matter of law that the plaintiff corrected its erroneous returns for 1932 to 1935 by requesting the Commissioner and his agents to correct the depreciation taken as a deduction thereon, and by the filing of amended returns for those years which did report the correct depreciation deduction.

10. The District Court erred in denying appellant's motion to reopen the case to introduce evidence of the fact that after the filing of the stipulation of facts, the Commissioner of Internal Revenue through his Agents did consider the amended returns filed by the appellant for the years 1932 to 1935 inclusive and accepted them as correct.

11. The District Court erred in failing to give judgment for appellant in the full amount prayed for in the complaint.

SUMMARY OF ARGUMENT.

The Appellant raises no objection to the Government's method of computing depreciation by taking the unexhausted cost of the property at the beginning of the taxable year and spreading it over an estimated useful life from the beginning of the year.

The Appellant concedes that the statute requires that the cost basis for depreciation must be reduced by not less than the allowable depreciation for prior years regardless of whether tax benefit was derived therefrom.

The Appellant concedes that the cost basis for depreciation must be reduced by the depreciation allowed in prior years even though in excess of the amount allowable *if* that depreciation was actually and legally allowed under the income tax laws applicable to that year, or *if* a tax benefit had been derived therefrom (estoppel).

The Appellant concedes that the mere fact that it did not obtain a tax benefit from the excessive depreciation deducted by it on its original tax returns for the years 1932 to 1935 inclusive, does not *in itself* justify a conclusion that the erroneous depreciation could not have been "allowed". (This concession is induced only by the *Virginian Hotel Corporation* decision which until modified or reversed must be recognized as a controlling decision on this point, although appellant believes that the record in this case emphasizes the merits of the views of the four dissenting Justices as expressed in the dissenting opinions in that case). However, the fact that the excessive de-

duction did not result in a tax benefit, *coupled* with the fact that the Commissioner knew that the deduction was excessive and that he and his agents challenged it and his agents corrected it, does justify the conclusion that the excessive depreciation was not allowed and could not have been allowed legally.

The question to be argued is confined by reason of these concessions to whether the excessive depreciation reported by the plaintiff on its original income tax returns for the years 1932 to 1935, inclusive, was "allowed under this Chapter or prior income tax laws" within the meaning of that phrase as used in the statute (Section 113 (b)(1)(B)); and the decision on this question is dependent entirely upon the application of the equities of the case and a reasonable and proper construction of the statute, to the stipulated facts. A summary of the appellant's argument is:

I.

The record shows that the tax returns for 1932 to 1935 were assigned to the field agents of the Commissioner of Internal Revenue for examination and audit. This in itself might be said to be a challenge of the returns and the items claimed as deductions thereon. Also, the record shows that the depreciation deducted on the original returns for the years 1932 to 1935 was excessive and was reported by mistake and the agents of the Commissioner did challenge and did correct it. These facts distinguish this case from the *Virginian Hotel Corporation* case and preclude a determination that the erroneous depreciation was "allowed under this chapter or prior income tax laws" within the

meaning of that term as used in Section 113(b)(1)(B).

II.

The action of the Commissioner sustained by the Court below, in wiping out approximately $2,000,000 of appellant's capital investment which it is conceded would have been returnable to the appellant through depreciation allowances in years after 1935 had the depreciation been correctly computed on the original tax returns for the years 1932 to 1935, is inequitable and unjust, and therefore in conflict with Section 113(b)(1)(B) and with the legislative intent that Section 113(b)(1)(B) be so administered as to accomplish equitable results.

The conclusion of the Commissioner and the Court below to the effect that the erroneous depreciation deduction taken on the original returns for 1932 to 1935 is conclusive and that no retroactive correction thereof may be made is in conflict with the expressed intentions of the Legislature that retroactive adjustments may be made if necessary to protect the interests of the taxpayer, for which reason no expressed prohibition against retroactive adjustments was inserted in Section 113(b)(1)(B).

III.

The Commissioner had no authority to "allow" the excessive depreciation deducted by appellant on its original 1932 to 1935 tax returns, because the amounts deducted were not authorized by the income tax laws; and when the Commissioner and his agents who chal-

lenged the deduction were on notice that the deduction did not comply with the income tax law and was not allowable thereunder, they had no power or authority to "allow" the erroneous deduction especially when the appellant had obtained no tax benefit from the erroneous deduction and could not therefore be estopped from demanding a correction of the erroneous deduction.

Although the Commissioner may not be bound by unaccepted conclusions of his agents, he is bound by their knowledge of the facts and cannot make a determination contrary to those facts. In this case the Agents knew that as a matter of fact the depreciation deducted on the original returns for the years 1932 to 1935 was excessive and unreasonable and therefore *not* allowable under the income tax statutes applicable to those years, so the Commisioner could not reject these facts and make a determination in conflict therewith and in conflict with the statute authorizing the depreciation deduction.

IV.

The appellant had the right to correct its mistake and did so by preparation of revised depreciation schedules in collaboration with the Commissioner's agents and by the filing of amended returns for the years 1932 to 1935 which reported the correct depreciation, and the Commissioner should have given effect to those corrections in the computation of the depreciation deduction for the years here involved.

The later examinations and acceptance of the amended returns by the Commissioner's Agents, evidence with respect to which the District Court excluded, is confirmation of those returns, and even though the Commissioner successfully opposed the introduction of evidence with respect thereto on the ground that the examination and acceptance of the returns was a mistake, there was no contention that the amended returns did not reflect the correct depreciation deduction and correct net loss. The Court below should have accepted the evidence, if not as evidence of the acceptance of the returns, then certainly as further evidence of a deliberate purpose on the part of the Commissioner to do nothing which might produce a fair and equitable result in this case for fear it might be in violation of the *Virginian Hotel Corporation* case. There is nothing in the income tax statutes or the *Virginian Hotel Corporation* case which prevents the Commissioner from considering and accepting the amended returns filed by appellant in this case. The Commissioner must administer the income tax laws according to their provisions and has no authority or right to refuse to make an allowance provided for by the statute, or to make an allowance which violates the statute.

In computing the basis for depreciation as of December 31, 1935 the cost of the property should not have been reduced by any amount greater than the stipulated reasonable, correct and *allowable* depreciation for the years 1932 to 1935.

ARGUMENT.

INTRODUCTORY STATEMENT.

The District Court was of the opinion that the *Virginian Hotel Corporation* case required the conclusion that the Commissioner "accepted" the tax returns for the years 1932 to 1935 when they were filed, and by reason of such acceptance of those returns the depreciation deduction taken thereon must be deemed to have been *conclusively* allowed (R. 111-112). The District Court seemed to be of the opinion that this was the proper construction of the *Virginian Hotel Corporation* decision regardless of the facts in this case showing that the Commissioner knew that the depreciation was erroneous, that through his agents the Commissioner challenged and corrected the depreciation even though he refused to give effect to the correction in the computation of the tax liability for later years, that the taxpayer itself corrected the depreciation through its contact and work with the Internal Revenue Agents and through the filing of amended returns for the years 1932 to 1935, and that the Government was not deprived of any taxes for the years 1932 to 1935. If this Court should be of the same opinion as the Court below as to the construction and effect of the *Virginian Hotel Corporation* decision, the judgment of the Court below will have to be sustained.

If this Court should conclude, as will be argued herein, that the *Virginian Hotel Corporation* case is distinguishable and therefore not controlling of the disposition of this case, and if this Court is satisfied

that regardless of that case the erroneous depreciation taken on appellant's original tax returns for the years 1932 to 1935 inclusive was not "allowed" within the meaning of that term as used in Section 113(b)(1)(B) of the Internal Revenue Code, the decision below should be reversed.

This argument therefore is so designed as, first, to show the inapplicability of the *Virginian Hotel Corporation* case, and second, to justify the allowance of the stipulated correct depreciation for the years 1932 to 1935 as the proper amount to be taken from the cost of the Appellant's buildings and furniture and fixtures to determine the unexhausted basis of that property as of December 31, 1935 for depreciation purposes.

I.

THE VIRGINIAN HOTEL CORPORATION DECISION IS LIMITED TO INSTANCES WHERE THE DEPRECIATION TAKEN IN PRIOR YEARS HAD NEVER BEEN CHALLENGED BY THE COMMISSIONER OR HIS AGENTS. SINCE THE PRIOR YEAR DEPRECIATION INVOLVED IN THE INSTANT CASE WAS CHALLENGED BY THE COMMISSIONER AND HIS AGENTS, THE VIRGINIAN HOTEL CORPORATION CASE IS INAPPLICABLE.

The only point decided by the U. S. Supreme Court in the *Virginian Hotel Corporation* case was that a depreciation deduction may have been allowed even though no tax benefit was derived therefrom.[2] The Supreme Court without the benefit of any evidence as

[2]See appendix for history of litigation in *Virginian Hotel Corporation* case, and further specification of its distinguishing features.

to the procedure for handling returns in the Bureau of Internal Revenue, volunteered a theoretical point of view as to the effect of the acceptance of a return upon the "allowance" of a deduction thereon by stating:

> " 'Allowed' connotes a grant. Under our federal tax system there is no machinery for formal allowances of deductions from gross income. Deductions stand if the Commissioner takes no steps to challenge them. Income tax returns entail numerous deductions. If the deductions are not challenged, they certainly are 'allowed' since tax liability is then determined on the basis of the returns. Apart from contested cases, that is indeed the only way in which deductions are 'allowed'. And when all deductions are treated alike by the taxpayer and by the Commissioner, it is difficult to see why some items may be said to be 'allowed' and others not 'allowed'. It would take clear and compelling indications for us to conclude that 'allowed' as used in Section 113(b)(1)(B) means something different than it does in the general setting of the revenue acts."

The Commissioner apparently construes this decision as *requiring* him to assert against the Appellant that by accepting a return, the depreciation deduction taken thereon is conclusively allowed whether or not he was fully aware that the deduction was excessive and illegal. However, the Commissioner must believe that the *Virginian Hotel Corporation* case does not apply and the deduction is not conclusive in cases where an adjustment of the depreciation will result in a tax, because he takes the position that if he has any

cause to reopen the return to make any adjustment which might result in a tax, he is not bound by the inferred allowance of the deductions from the previous acceptance of the return, and may disallow the excessive depreciation and thus increase the tax.[3]

He does not seem at all disturbed by the inconsistency between his position that he need not treat the deduction as having been allowed if he can levy a tax thereby, and his position that he must treat the deduction as having been conclusively allowed if he can injure the taxpayer thereby.

The District Court, too, in sustaining the Commissioner, construed the *Virginian Hotel Corporation* decision as holding that the acceptance of a return is conclusive against the taxpayer. The District Court seemed to think that even the Commissioner was foreclosed from correcting the erroneous deduction. The District Court concluded:

> "Disclosure of the excessive depreciation claimed and disallowance of its deduction by Revenue Agents or by the Commissioner does not authorize the latter to rectify the taxpayer's mistake or error of judgment. I am unable to perceive any basis for a different conclusion in this case from that enunciated in the *Virginian Hotel Corporation* case, infra." (R. 112.)

We respectfully submit that this conclusion is induced by a misconstruction of the *Virginian Hotel*

---

[3]R. 30, Stip. ¶ 6a; this actually happened in this case when the agents of the Commissioner reopened the year 1936 return after it had been "accepted". See also I.T. 2944, infra p. 45, footnote.

Corporation decision and is not in accord with the pertinent income tax laws which prescribe the type and amount of deductions *which may be taken or allowed* on an income tax return.

Both the Commissioner and the District Court give no significance to the reference several times made by the Supreme Court in the *Virginian Hotel Corporation* decision to the lack of challenge by the Commissioner or his agents, of the claimed deduction. At the very beginning of its opinion the Supreme Court stated "No objection was taken by the Commissioner or his agents to the amounts claimed and deducted." In the portion of the Court's opinion quoted above (supra, p. 37) appear the statements—"deductions stand if the Commissioner takes no steps to challenge them," and "if the deductions are not challenged; they certainly are 'allowed' * * *". The Commissioner and the District Court extend the decision as though the Supreme Court intended it to apply whether or not the deductions had been challenged. It is respectfully submitted that since the Supreme Court deemed it important to specifically qualify its decision by limiting it to instances where the claimed deductions had not been challenged by the Commissioner, the decision is inapplicable to a case, such as the instant case, where the claimed deductions were challenged. The decision is absolutely silent as to the status of an erroneous deduction once it has been challenged. The limited nature of the issue and the limited record before the Supreme Court precluded any consideration of the answer in such a situation (see Appendix hereof).

We can accept the *Virginian Hotel Corporation* decision for the proposition that the mere fact that the excessive depreciation deducted in the prior years did not result in tax benefit, does not mean that the deduction was not allowed. But the answer to the question in this proceeding of whether the challenged excessive depreciation deduction was allowed, and whether the excessive deduction could be corrected, must be determined from all the facts in the case and the applicable statutory provisions independent of the Supreme Court decision in the *Virginian Hotel Corporation* case which as we have just demonstrated does not apply where the prior year depreciation was challenged by the Commissioner or his Agents.

II.

THE LEGISLATIVE PURPOSE OF PERMITTING THE BASIS TO BE REDUCED BY ALLOWED DEPRECIATION, WAS TO AUTHORIZE THE APPLICATION OF THE DOCTRINE OF ESTOPPEL AGAINST TAXPAYERS SEEKING TO CHANGE THE DEPRECIATION DEDUCTION WHERE TO PERMIT SUCH CHANGE WOULD LEAD TO INEQUITABLE RESULTS. THE STATUTE WAS NOT INTENDED AS AUTHORITY FOR THE ALLOWANCE OF AN ILLEGAL DEDUCTION TO ACCOMPLISH AN INEQUITABLE RESULT AGAINST THE TAXPAYER.

(a) Legislative history of Section 113(b)(1)(B) shows that the legislature intended that retroactive adjustments of depreciation should be made where necessary to correct errors and to protect the interests of the taxpayer.

The basis for determining gain or loss on the sale or exchange of property, if acquired after February 28, 1913, is its cost, adjusted as in subsection (b) of

Section 113 of the Code. The basis for determining the amount of the deduction for depreciation is the same. (Section 114(a) of the Internal Revenue Code.)

The present law, subsection (B), as amended in the Revenue Act of 1932, requires the adjustment to the basis:

> "(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws."

The earliest provisions in the Revenue Acts with respect to the adjustment to the basis for depreciation and similar deductions is in Section 202(b) of the Revenue Act of 1924, that proper adjustment be made for the deductions previously "allowed".[4]

The then Solicitor of the Bureau of Internal Revenue construed the word "allowed" in Section 202(b)

---

[4]The earlier Revenue Acts (prior to 1924) contained no provision similar to subsection (B). The adjustment to the basis of property was, however, made the subject of Treasury Department regulations, the validity of which was being contested (*United States v. Ludley,* 274 U. S. 295) when the Revenue Act of 1924 was under consideration and the following provision was made a part of section 202(b):

> "In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for * * * exhaustion, wear and tear, obsolescence, amortization, or depletion, previously allowed with respect to such property."

The Committee on Ways and Means stated that the above provision was substantially the same as the then existing Treasury regulations. Report No. 179, 68th Cong., 1st Sess., page 12. The existing regulations were in Article 1561 of Regulations 45 and 62, and provided:

> "* * * proper adjustment must be made for any depreciation or depletion *sustained.*"

of the 1924 Act to mean "actually granted". In his Memorandum 4249[5] he stated that the subsection "contemplates an adjustment to the 'basis' only for deductions which have in prior years been actually granted by the Commissioner in computing the net income of the taxpayer."

The Treasury Department found that the 1924 Act did not provide for an adjustment in the case of property acquired prior to March 1, 1913, for depreciation sustained prior to that date; and Section 202(b) was amended by the Revenue Act of 1926 to provide that adjustment be made for the deductions previously "allowable"[6]. Section 202(b) of the 1926 Act was made Section 111(b)(2) of the Revenue Act of 1928.

The Treasury Department soon found fault with Section 111(b)(2), because there were instances of taxpayers who, in prior years, had deducted from income more depreciation than was allowable, and these taxpayers, in later years, asked that the deduction be reduced to the amount allowable, at a time when it was too late for the Government to collect

---

[5]Cum. Bul. IV-2, 1925, page 15.

[6]In the Revenue Act of 1926, the subsection was amended to read: "The basis shall be diminished by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion which have since the acquisition of the property been allowable in respect of such property under this Act or prior income tax laws." In Senate Report 52, Senate Finance Committee, 69th Congress, 1st Session, it is stated: "The bill as passed by the House provides that the cost or March 1, 1913 value in the case of a sale shall be reduced by the amount of depreciation or depletion allowable under prior income tax acts in computing the gain subject to tax. It is believed that the rule stated by the House bill is the correct rule and that all taxpayers should be required to take proper annual deductions for depreciation and depletion."

the additional tax that might be due on the resulting increase to income in the prior years. This led to the 1932 amendment to specifically preclude the possibility that a taxpayer might claim the same depreciation deduction a second time and after the Government might be barred by the Statute of Limitations from collecting the tax that would be due for the year in which the deduction was first claimed. *The purpose was to protect the Government from loss of tax in a barred year—not to prejudice the taxpayer who would owe no tax.* The legislative intent is well stated in the Committee report[7] in the following sentences:

> "In subparagraph (B), relating to depreciation, etc. for the period since February 28, 1913, the bill requires that adjustment be made to the extent allowed (but not less than the amount allowable) instead of by the amount * * * allowable as in the prior act. The Treasury has frequently encountered cases where a taxpayer, who has taken and been allowed depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact allowable were much less. By this time the Government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's present contentions. The Treasury is obliged to rely very largely upon the good faith and judgment of the taxpayer in the determination of the allowances for deprecia-

---

[7]Report No. 708 of the Committee on Ways and Means, 72d Cong., 1st Sess., page 22, repeated in Senate Report No. 665, same session, page 29.

tion, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayer, and the Treasury should not be penalized for having approved the taxpayer's deductions. While the committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility."

The Senate Finance Committee in its report added the following very enlightening statement:

"Your committee has not thought it necessary to include any express provision against retroactive adjustments of depreciation on the part of the Treasury as the regulations of the Treasury seem adequate to protect the interests of taxpayer in such cases. These regulations require the depreciation allowances to be made from year to year in accordance with the then known facts and do not permit a retroactive change in these allowances by reason of the facts developed or ascertained after the years for which such allowances are made."[8]

It seems obvious that the legislature though prohibiting a retroactive adjustment of depreciation in order to protect the Government against inequitable claims, intended specifically to recognize the right to make a retroactive adjustment where such an adjustment was required to "protect the interests of the taxpayer". Since the legislature expressly stated it

[8]Treasury Regulations 74, Articles 205 and 561 (substantially similar to Articles 23(1)5 and 113(b)1, supra pages .... and ....).

was not making provision against retroactive adjustments it certainly did not intend that the law should be so administered that the Commissioner could refuse to make a retroactive adjustment to the prejudice of the taxpayer or that the Commissioner could conclusively bind the taxpayer to an error. *The Legislature seemed satisfied with the existing Act requiring an adjustment of cost for "allowable" depreciation excepting only in those instances where to ignore the amount of depreciation actually allowed would result in the inequity described in the Committee reports.*

In 1935, the Commissioner issued I. T. 2944, Cum. Bul. XIV-2, page 126,[9] and therein stated:

---

[9]I.T. 2944, Cum. Bul. XIV-2 (1935), p. 126:

"Advice is requested whether the deduction for depreciation claimed on an income tax return which has been accepted by the Bureau constitutes depreciation 'allowed' for the purpose of adjusting the basis to be used in computing gain or loss, depreciation, exhaustion, or obsolescence in subsequent years controlled by the Revenue Acts of 1932 and 1934.

"Sections 113(b) and 114(a) of the Revenue Acts of 1932 and 1934 in effect provide that the basis for such purposes shall be adjusted for exhaustion, wear and tear, and obsolescence to the extent allowed (but not less than the amount allowable) for any period since February 28, 1913. The word 'allowable' designates the amount permitted or granted by the statutes, as distinguished from the word 'allowed' which refers to the deduction actually permitted or granted by the Bureau. The amount 'allowable' is the minimum for adjustment purposes, the amount 'allowed' serving to measure the adjustment only when the amount thereof exceeds that allowable.

"It follows that the depreciation claimed as a deduction in a return which has been accepted by the Bureau is the amount 'allowed' for that year. The amount 'allowed' for any year may be adjusted to the amount 'allowable' at any time within the statutory period applicable thereto for purposes of computing the proper deduction for such year and of adjusting the basis. The statute, however, requires adjustment of the basis to accord with the amount 'allowed' or the amount 'allowable', whichever is greater, irrespective of any statute of limitations applicable to the year of deduction."

> "It follows that the depreciation claimed as a deduction in a return which has been accepted by the Bureau is the amount 'allowed' for the year."

There was no explanation in this ruling of what was intended to be meant by the word "accepted".

In such manner was the meaning of the word "allowed" changed from "actually granted by the Commissioner in computing the net income of the taxpayer", as in the Solicitor's 1925 Memorandum 4249, Cum. Bull. IV-2, page 15, to "claimed as a deduction in a return which had been accepted by the Bureau", as in the 1935 Income Tax ruling. The next step was the ruling made in this case and sustained by the District Court, that *any return filed,* whether or not audited or corrected by the Commissioner or his agents, *is accepted,* and as against the taxpayer the depreciation taken thereon is automatically and conclusively allowed whether right or wrong.[10] This position is in direct violation of the expressed intention of the Legislature that there should be no prohibition against retroactive adjustments and that the interests of the taxpayer should be protected. It was only in cases where the Government's interest would be prejudiced *by the loss of tax* through the bar of the statute of limitations, or where an adjustment was indicated only by after-discovered facts, that retroactive adjustments were to be prohibited. In directing attention to the

[10]The District Court seemed of the opinion that even the Commissioner could not correct the erroneous deduction, the Court stating:

> "Disclosure of the excessive depreciation claimed and disallowance of its deduction by Revenue Agents or by the Commissioner does not authorize the latter to rectify the taxpayer's mistake or error of judgment" (R. 112).

Commissioner's regulations which permit of retroactive adjustment in the case where the depreciation was in error based upon the facts known at the time the depreciation was deducted (supra, p. 44), the Legislature acknowledged that retroactive adjustments might be made in such cases especially where necessary to reflect the proper allowable depreciation and to protect the interests of the taxpayer. That is exactly the type of case which is before this Court in this proceeding. The decision of the District Court to the effect that the erroneous deduction taken on the original returns for 1932 to 1935 could not be corrected even though known to be erroneous at the time deducted on the basis of facts then known, is directly in conflict with the legislative intent as to the purpose of Section 113(b)(1)(B) and as to the manner in which it should be administered.

In summary, we conclude from the foregoing analysis that the legislative history of Section 113(b)(1)(B) shows that the legislature was convinced that the correct rule for reducing the cost by depreciation was (1) that it should be reduced by depreciation "allowable in respect of such property under this Act or prior income tax laws" (footnote 6, p. 42, supra); (2) that retroactive adjustment of the depreciation taken on the return should not be made where the depreciation was not challenged by the Commissioner and any adjustment would result in the allowance of an inequitable claim against the Government, or where the adjustment could be supported only by facts developed or ascertained after the years for which the depreciation was taken, in which cases the depreciation taken

would be considered to be "allowed" and would take the place of the amount allowable; and (3) that retroactive adjustment should be made where it is necessary to correct an error in the depreciation on the basis of facts known at the time, to protect the interests of the taxpayer, and to avoid inequities, especially where the depreciation was challenged by the Commissioner or his agents.

There is nothing in the *Virginian Hotel Corporation* case in conflict with the above-stated conclusions as to the legislative intent as to the purpose of Section 113(b)(1)(B) and the manner in which it should be administered. The Supreme Court examined the legislative intent only to the extent necessary to determine how Section 113(b)(1)(B) should be applied in the instance where depreciation taken on a prior year return was *never* challenged by the Commissioner or his agents, and where no tax benefit was derived from the deduction. We believe that our conclusion (2) in the previous paragraph hereof is consistent with the Court's decision as to the legislative intent as applicable to that single situation. The Court had no occasion to extend its decision to the determination of the legislative intent as applicable to factual situations similar to those existing in the instant case as, for example, where the depreciation had been challenged by the Commissioner or his agents, and our conclusions (1) and (3) as to the legislative intent as applicable to those situations relate to matters not decided or considered in the *Virginian Hotel Corporation* case.

There is no question that if the conclusions hereinbefore stated as to the legislative intent are correct, the appellant's position in this case that the erroneous depreciation taken in the years 1932 to 1935 and challenged by the Commissioner, should be corrected, is sound and should be sustained, and the decision of the District Court to the effect that no retroactive adjustment could be made under the law, should be reversed.

We have made mention several times of the apparent intention of the Legislature that the only purpose of the 1932 amendment of Section 113(b)(1)(B) was to prevent inequities against the Government, and we have emphasized that the Legislature intended that the interests of the taxpayer, too, should be protected against inequitable results. The District Court was not impressed with the equities in this case concluding "It is not unfair nor unjust to compel such a taxpayer to accept the consequences of such procedure, even though, as presently asserted, the motive was not ulterior, but that the procedure was a mistake". We think the Court's view is much too severe. It seems to us to be most unfair to deny to the taxpayer the right to correct a mistake which, unless corrected, will cost the taxpayer $600,000. There are so many circumstances which, we think, justify the conclusion that the taxpayer's position in this proceeding is fair, equitable, and just, that a brief statement of them should be submitted before concluding this section of the Argument, so we submit the following to point out that unless the equities of the taxpayer's position are recognized, Section 113(b)(1)(B) will be given effect

in a manner contrary to the intention of Congress as to the purposes to be accomplished by the section.

(b) The application of Section 113(b)(1)(B) in the manner in which it was applied by the Commissioner in this case is unjust and inequitable and contrary to the intention of Congress as to the purposes to be accomplished by the section.

It is true that the matter of equity cannot in itself be the basis for the determination of a strictly legal question. But the matter of equities, good faith, and plain justice should have its influence as a check upon whether a statute is being properly construed or applied within the intention of the legislature which enacted it. This is especially true here where as hereinabove pointed out, the Congress at the time it passed this statute was thinking of accomplishing equitable results and protecting the interests of the taxpayer as well as the interests of the Government. The purpose of the statute was to assure equitable results, not to impose inequitable results or injury upon taxpayers.

The Congressional Committees had in mind two types of cases in which retroactive adjustments of the depreciation allowance would be inequitable and would be prohibited by the amendment of Section 113(b)(1)(B), in order to protect the interests of the Government:

(1) Where the adjustment would result in an additional tax which would be barred from collection.

(2) Where the adjustment would be based upon facts developed or ascertained in later years.

This case does not fall within either of these classes. The correction of the depreciation in this case does not result in any additional taxes; and the correction is not based upon a later discovery of facts but upon facts stipulated as being known at the time the deductions were taken.

The Senate Finance Committee thought that retroactive adjustments of the depreciation allowance could be made in other cases "to protect the interests of the taxpayer in such cases". In this case, retroactive correction of the depreciation allowance for the years 1932 to 1935 should be made to protect the interests of the taxpayer.

The Government was on notice at all times after the filing of the returns for 1932 to 1935 that there was something wrong about the depreciation deduction taken on the return. The Government agents who examined the returns confirmed this and corrected the errors. The corrections were set forth in amended returns. There was no tax liability so there was no tax barred from collection. These facts and other facts hereinafter described relating to the original reporting of the erroneous deductions and the appellant's efforts to correct the error negative any idea that the appellant is making an unfair or inequitable claim in this case.

The appellant's employees took certain depreciation deductions on the tax returns for the years 1932 to 1935, inclusive, knowing at the time that the deductions were wrong (R. 62, Stip. ¶ 31c). The appellant's

administrative officials, though signing the returns, did not know this but assumed that the returns were properly prepared (R. 67, Stip. ¶ 33). Technically, the negligence or mistake of its employees in preparing these returns may be imputed to the appellant but the practicalities which are common to any large organizations having departmentalized functions should be recognized.

The taxpayer's tax department, its accounting department, and its head office or executive department were located in different buildings (R. 62, Stip. ¶ 31c). Each performed certain functions reflected in the preparation of the tax return. The tax return was extremely complicated and book items of income and deductions were so reclassified and summarized when transcribed upon the return that it was impossible from a mere inspection of the return to identify the book items (R. 61, Stip. ¶ 31a). The returns showed large net losses and no income tax liability (R. 44, Stip. ¶ 12, 13). Under these circumstances it was only reasonable conduct for the administrative officials of the appellant to assume, without investigation, that the return was correctly prepared and to sign the return. Nevertheless the stipulations show that the returns were not correctly prepared and that the employees who prepared them knew that they were not correctly prepared but thought that they could be corrected at any time (R. 62, Stip. ¶ 31c). So, aside from the legal point hereinafter further argued that an illegal deduction whether or not taken by mistake, cannot be "allowed", as a matter of equity this appellant should

not be so shackled by the errors of its employees that it should have no opportunity to correct those errors. It would be most inequitable to so construe or administer the statute as to impose unconscionable taxes upon the premise of refusing this appellant the right to correct mistakes. The Legislature was of the opinion that Treasury Regulations permitted retroactive corrections in such a case (supra, p. 44). We do not believe that Congress ever contemplated that taxpayers must be infallible or suffer the consequences of their mistakes.

Just what does this situation mean to this appellant? The accumulated error in taking excessive depreciation in the original returns for the years 1932 to 1935, inclusive, results in the reduction of the basis for depreciation as of December 31, 1935 of approximately $2,000,000. Had the returns been properly prepared the appellant would have had additional capital investment of $2,000,000 *properly* recoverable through depreciation allowances in later years (as to furniture and fixtures, 12 years, and as to buildings, a longer period). If an average effective tax rate of 30% over the period in which this $2,000,000 should be recoverable is assumed, it is obvious that there is a tax of around $600,000 which the Commissioner by his position in this case is, we contend, inequitably exacting from appellant. In other words the construction of the statute in such manner as to preclude appellant from correcting conceded errors, will result in the exaction of a tax of $600,000 which admittedly would not be due if the conceded errors were corrected. In

this connection we think the remark made by the Circuit Court of Appeals for the Fifth Circuit in its decision in the case of *Anna I. Hilpert v. Commissioner* (1945), 151 F. (2d) 929, is most appropriate:

> "The appetite for taxes is not so voracious, the commands of the statute are not so inexorable, as to require the doing of an injustice when there is another course that is more fully consonant with law and reason and which course, if followed, will lead neither to evasion by the taxpayer nor extortion by the Government."

As a further matter of equity, appellant should not be so prejudiced by the Commissioner's income tax departmental procedure and practices that it cannot be relieved of this substantial and unfair tax burden. The stipulations show that appellant has been trying for nine years to obtain a correction of the mistake in its report of depreciation on its tax returns for the years 1932 to 1935; that since January, 1937, it has been constantly and consistently asking the Government to make the correction or cooperate with it in establishing a mutually acceptable basis for the correction (R. 63, Stip. ¶ 32); that for several years the Government agents, though admitting that a mistake existed and should be corrected, refused to correct it or to help the appellant in making proper corrections because to do so would violate an office practice or rule that no time or work should be devoted to a case unless a tax liability was involved (R. 50, Stip. ¶ 19-20). True, the appellant could have filed amended returns sooner than it did but those returns were not neces-

sary so long as there was a possibility that the depreciation could be adjusted and settled with the Government agents which in fact was actually accomplished even though the reports of the agents were later rejected by the Bureau of Internal Revenue at Washington, D. C. When it became necessary to file the amended tax returns for the years 1932 to 1935, the appellant filed them, correcting therein the depreciation reported on the original returns (R. 67, Stip. ¶ 32i). Even on the basis of the amended returns there was no tax liability for those years. The interests of the Government were not jeopardized in the slightest by the delay in filing amended returns. The returns did nothing more than present on a return form what the appellant had been presenting to the Commissioner in other ways for almost nine years.

The Bureau's position could well be stated to be that the depreciation was allowed because under its procedure the Bureau could not take time to correct it, even though knowing it to be wrong; and since it was allowed in that manner it thereby became a correct deduction which the taxpayer is forever precluded from questioning no matter how illegal the deduction or how unfair, unjust or harsh the burden resulting from such allowance. There can be little question that such a position is most inequitable if not illegal, and most prejudicial to the interests of the taxpayer. The Government is applying the statute to justify the Commissioner in the very wrong the statute was intended to correct. The statute condones the allowance of an illegal deduction where in doing so an inequitable

result is prevented; the Commissioner cites it as justification for allowing an illegal deduction where in doing so an inequitable result is accomplished.

The Government's position means that no matter how erroneous or excessive is the deduction, and no matter how well informed the Commissioner might be that the deduction is erroneous, the Commissioner alone has the exclusive right to correct the deduction. He can correct it if by doing so he can collect more taxes; he can refuse to correct it if by doing so he can collect more taxes. The rights of the taxpayer are completely ignored in this picture and the taxpayer is bound by a mistake even to the extent of being deprived of any right or means of correcting the mistake, and being forced to suffer the consequences of an illegal deduction even though the legal and equitable rights of the Government were not prejudiced by the taxpayer's mistake and would not be prejudiced by a correction of the mistake. This result is directly in conflict with the legislative purpose of Section 113(b)(1)(B) to effect equitable results.

It is respectfully urged that the Congress when enacting Section 113(b)(1)(B) intended only to codify the principle of estoppel in its application to cases where the correction of an error in the depreciation would lead to inequitable results (see supra, p. 43). In no other instance is there any statutory authority for the allowance of an illegal deduction, and, as will hereinafter be further argued, an illegal deduction for depreciation cannot be allowed where the correction of that deduction will not lead to inequitable results.

The Legislature intended, expressly, that retroactive corrections of the depreciation should be made where necessary to protect the interests of the taxpayer as well as the interests of the Government.

It is true that in the *Virginian Hotel Corporation* case the Supreme Court held that the acceptance of prior year returns effected an allowance of the depreciation taken thereon under circumstances where there were no grounds for estoppel to prevent the taxpayer from requesting a correction of that depreciation. But, as pointed out in the appendix hereof there was no evidence in that case that a retroactive correction of the prior year depreciation was in order because the Supreme Court emphasized that the Commissioner had never challenged or objected to that depreciation; and the extremely limited nature of the issue prosecuted and decided in that case did not in itself indicate that the result of the Commissioner's action, sustained by the Supreme Court, was inequitable. There is nothing in the *Virginian Hotel Corporation* case in conflict with the conclusions herein expressed as to the legislative intention as to the purposes of Section 113(b)(1)(B).

The facts in the instant case show quite clearly as hereinbefore described that the action of the Commissioner approved by the District Court results in hardship and inequities, and in conclusions contrary to the intention of the Legislature as to the purposes to be accomplished by Section 113(b)(1)(B).

III.

NO ADJUSTMENT CAN BE MADE UNDER SECTION 113(b)(1)(B) FOR AN ILLEGAL DEPRECIATION DEDUCTION WHICH THE COMMISSIONER NEVER HAD AUTHORITY TO ALLOW AND THEREFORE COULD NOT ALLOW, UNLESS UNDER THE DOCTRINE OF ESTOPPEL THE TAXPAYER IS ESTOPPED FROM CONTENDING THAT THE DEDUCTION WAS ILLEGAL AND HAD NOT BEEN ALLOWED. IN THIS CASE APPELLANT IS NOT ESTOPPED FROM MAKING SUCH CONTENTIONS.

(a) When the Commissioner found that appellant's depreciation for the years 1932 to 1935 was erroneous and not allowable under the statute authorizing the deduction, he had no authority to allow the deduction either affirmatively or constructively.

Section 113 (b)(1)(B) provides that the base of depreciable property is to be reduced by depreciation "to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws". The Commissioner contends that by accepting Appellant's returns for the years 1932 to 1935 inclusive, the depreciation taken thereon was "allowed" within the meaning of the above section. It must follow that the Commissioner contends that by accepting the returns for 1932 to 1935 he allowed the depreciation taken thereon under the Income Tax Acts of 1932 and 1934 which were applicable to those years. The authority for the allowance of the depreciation deduction for those years is contained not in Section 113 which relates solely to the basis for depreciation (or for gain or loss), but in Section 23 of those Acts (23(k) of the 1932 Act and 23(l) of the 1934 Act) which provides that there shall be allowed as a deduction "a reasonable allowance for the exhaustion, wear

and tear of property used in the trade or business, including a reasonable allowance for obsolescence". A depreciation deduction must come within this statutory provisions to be allowable. *The Commissioner has no authority to allow any deduction which does not come within the statutory provision.*

The United States Supreme Court stated in the case of *New Colonial Ice Co. v. Helvering* (1934), 292 U. S. 435, 54 Sup. Ct. 788, 78 L. Ed. 1348, 13 A.F.T.R. 1180:

> "Whether and to what extent deductions shall be allowed depends upon legislative grace, and only as there is clear provision therefor can any particular deduction be allowed."

This rule was applied to depreciation in the case *Jefferson v. Clearfield, Coal & Iron Co. v. U. S. Court of Claims,* 1936, 14 Fed. Supp. 918, 17 A.F.T.R. 871, certiorari denied, where the Court held that deductions from gross income for exhaustion of wasting assets, depletion or depreciation may be taken by the taxpayer only in the amount allowed *by the statute.*

The Commissioner may allow a deduction not knowing that it did not come within the statutory provision, but if he knows as in this case, that a deduction has been taken which is not allowable under the statute, he cannot allow the deduction in contravention of the statute. Neither can he arbitrarily allow, or have the right to elect to allow, a deduction for which there is no authority in the Statute; if he tried to exercise such authority he would be exercising legislative

power which would be a usurpation of the powers of Congress. This rule cannot be affected by regulation or practice of the Commissioner of Internal Revenue. It is a recognized principle that:

> "The power of an administrative officer or board is to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity." *Lynch v. Tilden* (1924), 265 U. S. 315, 320-322, 44 S. Ct. 488, 4 A.F.T.R. 3980.

After the Internal Revenue Agents challenged the depreciation deductions taken by Appellant on its original returns for the years 1932-1935, and corrected them, the Commissioner had no right to repudiate or disavow the acts of his agents. He may reject the conclusions of his agents but he cannot escape the imputation of the facts discovered by them and he cannot ignore those facts to justify a conclusion not sustainable on the basis of these facts. The facts divulged to and verified by the Agents are stipulated as true in this proceeding. Under those facts there could be no other conclusion than that the depreciation taken in the years 1932 to 1935 was excessive under conditions known at that time and the Commissioner was thereupon bound to make a determination of the cor-

rect depreciation allowable under the Statute.[11] His ruling in this case resulted in a determination not authorized by Statute and in the "allowance" of a depreciation deduction which violated the Statute. (Section 23). The Commissioner cannot invade the field of legislation and make an "allowance" not authorized by Statute. It was his duty and obligation to make a determination and an allowance of depreciation in accordance with the Statute. (*Commissioner v. Van Vorst* (CCA.-9, 1932), 59 Fed. (2d) 677, 11 A.F.T.R. 562). With knowledge of the facts as to Appellant's depreciation and the mistake on its original returns for the years 1932 to 1935, there was only one determination which the Commissioner could have made to be within the requirements of the income tax laws, and that was to do what his agents did, to ascertain and allow the correct depreciation allowable for those years under the Statutes applicable thereto.

The principle against permitting the Commissioner to use his own discretion about strict compliance with the Statute was also applied in the case of *F.H.E. Oil Co. v. Commissioner* (C.C.A.-5, 1945), 147 F. (2d) 1002, holding invalid a Treasury regulation granting taxpayers the option to expense intangible costs of drilling oil wells, on the ground that such costs were

---

[11]Senate Report No. 665, 72d Cong., 1st Sess., supra p. 43.

Regulations 101, Article 23(l)5, supra p. 23:

"The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made."

Com. v. Mutual Fertilizer Co. (C.C.A.-5, 1947), 159 F. (2d) 470;

Com. v. Cleveland Adolph Mayer Realty Corp. (C.C.A.-6, 1947), 160 F. (2d) 1012.

capital expenditures and the Commissioner had no authority to allow them as deductions; also in the cases of *Central Real Estate Co. v. Commissioner,* (C.C.A.-5, 1931), 47 F. (2d) 1036, 9 A.F.T.R. 1056, and *H. M. O. Lumber Co. v. Commissioner* (C.C.A.-6, 1932), 59 F. (2d) 907, 11 A.F.T.R. 614, holding the Commissioner could not allow an option for treating carrying charges as capital additions or as expense since such items were not capital items under the statute.

It is obvious that under the circumstances of this case, the Commissioner would be prohibited from *affirmatively* allowing a depreciation deduction which he knew was not authorized by Statute—it must necessarily follow that he cannot *constructively* allow it by doing nothing or by accepting the return on which it is reported. Once the deduction is recognized as an illegal deduction there is nothing in the Statute which would permit it to be allowed under any circumstance, and as will hereinafter be pointed out, Appellant is not estopped from making and relying upon this contention.

In this case, when the Commissioner and his agents learned that the depreciation taken on the original returns for the years 1932 to 1935 were not allowable under the only section of the income tax laws (Sec. 23) which authorized the deduction, the Commissioner was without power to allow that deduction either affirmatively or constructively. He cannot compel an incorrect return (*Wheelock v. Commissioner,* 28 B.T.A. 611). He had no power to allow the deduction by

accepting the incorrect return—therefore he cannot say at a later date that by accepting the return he allowed the deduction.

The view of the District Court in this case that the Commissioner cannot change a taxpayer's mistake in claiming an illegal deduction and must therefore be deemed to have "allowed" this deduction is absolutely contrary to the authorities just hereinbefore cited. Under these authorities it is clear that the Commissioner may act only as permitted by law and may allow only such deductions as are authorized by the Statute, and it is clear too that the taxpayer may take or be allowed only such deductions as are allowed by the Statute. There is absolutely no authority for the taking or for the allowance of a deduction on an income tax return unless that deduction is specifically authorized by the income tax laws[12].

---

[12]*Merten's Law of Federal Income Taxation* (a text published by Callaghan & Co., Chicago): Vol. 1, p. 69, Sec. 3.08—"Construction of Deduction and Privilege Provisions—The rule that ambiguities must be resolved in favor of the taxpayer is likewise inapplicable to deduction provisions of taxing acts. Deductions, like exemptions, are privileges, and must be narrowly construed. They will be allowed only when granted by clear language. The burden is on the taxpayer to show that he comes within the terms of the Statute granting the privilege. The general rule here discussed is often expressed as follows: 'Deductions are a matter of legislative grace.'" P. 89, Sec. 3.21—"The Commissioner may not make an arbitrary or unreasonable regulation, nor can the Treasury Department repeal or enlarge the scope of a Statute, supply a supposed omission, create an exemption, limit any rights thereunder, nullify a prior judicial construction of the Statute, alter or amend it in any way, particularly where an income tax might be so converted into a capital levy."

Vol. 4, p. 4, Sec. 23.01—"One of the familiar deductions to taxpayers is the deduction provided for 'depreciation' * * * The allowance, like all other deductions, is a matter of legislative grace * * *" (Extensive citations referred to in the text in support of the above statements are here omitted).

(b) Appellant is not estopped from correcting the erroneous deduction or from contending that the deduction was illegal and had not or could not have been allowed.

If an illegal deduction had been allowed in such a manner that the taxpayer had obtained a benefit therefrom, and later the taxpayer finds it to his advantage to make claim for a correction of the deduction at a time when the Government would be barred from collecting any additional tax which might result from the correction, then the taxpayer would be estopped from contending that the deduction was illegal.[13] It appears from the legislative history of Section 113 (b)(1)(B)[14] that Congress intended by its use of the word "allowed" to recognize this principle of estoppel,

---

[13]*Robinson, Exec. v. Comm.*, 100 F. (2d) 847 (C.C.A.-6, 1939), certiorari denied.

> "Equitable estoppel applies in tax cases when the following correlative facts are present: The taxpayer, by his conduct, which includes language, acts or silence knowingly makes a representation or conceals material facts which he intends or expects will be acted upon by taxing officials in determining his tax, and the true or concealed material facts are unknown to the taxing officials or they lack equal means of knowledge with the taxpayer, and act on his representation or concealment and to retrace their steps on a different state of facts would cause the loss of taxes to the Government. A weighty factor in determining the application of the principle is the availability of the necessary facts to the parties involved."

Berch v. U. S. (Ct. Cl. 3/6/44), 54 F. Supp. 175, 32 A.F.T.R. 581;

Clifton Mfg. Co. v. Comm. (C.C.A.-4, 1943), 137 F. (2d) 290, 31 A.F.T.R. 386, rev'g. 1 T.C. 71;

John Milton, 33 B.T.A. 4;

Stern Bros. v. U. S., 8 F. Supp. 705, Ct. Cls. 1934, 14 A.F.T.R. 987;

R. H. Stearns Co. v. U. S., 291 U. S. 54, 54 S. Ct. 325, 13 A.F.T.R. 842;

Tidewater Oil Co. (1934), 29 B.T.A. 1208;

Mrs. R. Z. Wheelock, 28 B.T.A. 611, aff'd C.C.A.-5, 1935, 77 F. (2d) 474, 16 A.F.T.R. 109.

[14]Supra, pp. 40 to 57.

and to classify any depreciation which could not be disturbed under that principle as allowed depreciation which should be taken from the basis of the property to determine the remaining or unexhausted base. But that is not the situation in this case. Appellant is not trying to take advantage of the Government or escape a tax. As hereinbefore pointed out, Appellant's position in this case is equitable and just, and the factors which justify the application of equitable estoppel are not present in this case.

In summary, depreciation can be said to be allowed (1) if in the adjustment of a tax liability the Commissioner affirmatively allows certain depreciation, or (2) if the depreciation was considered in the computation of a tax liability and the taxpayer is estopped from claiming it to have been erroneous, or (3) if the depreciation had never been challenged or objected to by the Commissioner or his agents and the return on which it was deducted was accepted.

Depreciation cannot be said to have been allowed if (a) it was not allowable under the law authorizing the deduction, (b) the Commissioner knew it to be erroneous, and (c) no tax benefit was derived therefrom, regardless of whether or not the return was accepted, because as hereinabove pointed out the Commissioner has no authority under such circumstances to allow the erroneous deduction. The instant case falls exactly within this category. For the purposes of Section 113 (b)(1)(B) any such depreciation must be corrected and it should be presumed that the Commissioner allowed, or the Commissioner should be required to

allow only the allowable portion thereof[15], and therefore only the correct depreciation deduction should be taken from the basis of the property in determining the remaining or unexhausted basis of said property as of a later date.

IV.

THE REPORTING OF ERRONEOUS DEPRECIATION FOR THE YEARS 1932 TO 1935, INCLUSIVE, WAS A MISTAKE. UPON THE COMMISSIONER'S REFUSAL TO CORRECT THE MISTAKE THE APPELLANT SHOULD NOT HAVE BEEN DENIED THE RIGHT TO CORRECT IT.

The record shows that in 1932 the appellant made a survey of its property as the result of which it made a new estimate of the life of the property and established revised depreciation rates and schedules, and it used these revised rates and schedules in computing the depreciation allowance recorded on its books and records for the years 1932 to 1935, inclusive (R. 57, Stip. ¶ 25). As to Furniture and Fixtures this allowance for depreciation recorded on the books for said years, is stipulated to be a reasonable allowance for depreciation (R. 58, Stip. ¶ 26a).

This stipulation establishes that the appellant's *books* reflected the correct depreciation for those years based on conditions then known to the appellant.

The appellant's employee who prepared the tax returns for those years did not report as a deduction

---

[15]The Legislature intended that the right to make retroactive adjustments to protect the interests of the taxpayer should be preserved, supra p. 44.

on the tax return, the depreciation written off on the books, but reported a very much larger amount (R. 46, Stip. ¶ 14, 15; R. 272). When he did this, he *then knew it was wrong* but he thought it would be corrected, and in any event that it could be corrected at any time (R. 62, Stip. ¶ 31c). When a newly engaged tax counsel for the appellant discovered the error early in 1937, he started active endeavors which extended over a period of eight years to effect such corrections of that error as would be satisfactory to the Commissioner of Internal Revenue (R. 63, Stip. ¶ 32). The stipulations establish quite clearly that the executive or administrative officials of the appellant who signed the returns did not know of the existence of this error, but they relied upon the tax department and assumed that the returns were being correctly prepared, and when they were told of the error, and told that all efforts to correct the error through audit of the returns by the Bureau of Internal Revenue had been futile, they executed amended returns for the Bank for the years 1932 to 1935, inclusive, to correct the error (R. 67, Stip. ¶ 33).

There can be no question that the record in this case establishes that the original returns for the years 1932 to 1935 contained an error or mistake in the depreciation taken thereon as a deduction. When such a mistake is made there are only two ways by which the mistake can be corrected; one, the audit and correction of the erroneous deduction by the representatives of the Commissioner of Internal Revenue, and two, the filing by the taxpayer of amended returns. The Com-

missioner refused to make the correction so the appellant was compelled to resort to the filing of the amended returns. It does not seem practical that under the facts in this case, the resort to the mere formality of filing an amended return would have been necessary to sustain appellant's position that a correction of errors should be made. However, the appellant did satisfy that formality and in a purely technical way it does have the effect of adding further strength to the appellant's position in this case.

The appellant did file amended returns for the years 1932 to 1935, correcting the error in the original returns. The Commissioner of Internal Revenue refused to consider them or give any effect to them (R. 37, Stip. ¶ 25), presumably because they were not filed until April, 1945. The delay in filing the amended returns is clearly explained in the stipulations and was not prejudicial to the Government since there was no tax liability for the years 1932 to 1935 even on the basis of the amended returns. The Bank's tax department thought they could be prepared at any time because no tax liability was involved, and its tax counsel not only was of the same opinion but was of the further opinion that the correction of the depreciation could be effected in the course of the audits of the tax returns for later years, thus making the filing of amended returns for the years 1932 to 1935 unnecessary (R. 60, Stip. ¶ 31, 32). *Treasury regulations require generally that the Government agents should advise the taxpayer as to the information to be submitted (Mim. 1470, C.B. XIII-1 p. 59, C.B. XV-2 p. 148) so*

appellant had the right to expect cooperation from the Government agents in the preparation of mutually satisfactory depreciation schedules. That there was good ground for appellant's opinion that the matter would be corrected is amply demonstrated by the fact that the correction was effected in the course of the audit of later year returns by the Government revenue agents and engineers, in negotiations which extended over a period of several years, and it was only because the Bureau of Internal Revenue in Washington, D. C. rejected the work of its agents in San Francisco that the correction was not given effect and that this Court proceeding had to be brought. As soon as the appellant had exhausted all means for securing an acceptance by the Bureau of Internal Revenue of the work of the Government agents in San Francisco, it filed the amended returns (R. 67, Stip. ¶ 32i). Under these circumstances there was no lack of diligence on the part of the appellant in its efforts to correct its errors or in the filing of the amended returns.

It is respectfully submitted that under the facts in this case, there is absolutely no justification for the Commissioner's position that appellant is conclusively bound by its mistake, and there is no justification for his refusal to consider or give effect to these amended returns, and the District Court was wrong in approving his actions. Appellant, as any other taxpayer, cannot be presumed to be infallible, especially in so complicated a matter as the preparation of income tax returns, and it should have the right to demand the correction of erroneous returns. As hereinbefore

pointed out (supra p. 47), the legislature when it enacted Section 113 (b)(1)(B) intended that the right to correct mistakes in the depreciation deduction should be recognized and preserved.

In the *Wheelock* case, 28 B.T.A. 611, the Board of Tax Appeals stated the rule as to the proper reporting of deductions and the correct computation of a tax liability as follows:

> "The mere failure of a taxpayer to take the proper deduction in each year does not permit him to take advantage of his mistake through an incorrect return in a later year, *nor does it permit the Commissioner to compel an incorrect return.* The law does not contemplate the adjustment in any part of an incorrectly computed tax by the incorrect computation of another tax. Unless barred by the stature of limitations, a taxpayer is not precluded from demanding a correct computation of his tax for a past year on the facts as they exist, whether originally reported or not." (Italics ours).

There is no question that the filing of amended returns is a recognized practice for correcting errors. In fact, there is no other way for a taxpayer to voluntarily correct a mistake in its original tax return and certainly it should be afforded an avenue for a lawful correction of a mistake. The Statute of Limitations relates to the assessment and collection of tax liability so there is no bar of the Statute of Limitations where, as in this case, there is no tax liability for the years for which amended returns are filed. The privilege of filing amended returns is well de-

scribed by the U. S. District Court for the District of Connecticut, in the case of *Milford Trust Co. v. United States,* decided October 31, 1945, 63 Fed. Supp. 618, as follows:

> "During the years involved there was, to be sure, no statutory authority for the acceptance of amended returns. Such amendments have, however, been accepted by the Commissioner of Internal Revenue for the purpose of correcting errors. They are not forbidden by statute, as they were in the case of capital stock tax returns, 26 U.S.C. 1202(a). Amended income tax returns have frequently been accepted, at least in cases where there has been no election involved. Pictorial Review Co. v. Helvering, 68 F. (2d) 766, 13 A.F.T.R. 594; Morrow, Becker & Ewing v. Commissioner, 75 F. (2d) 1, 10 A.F.T.R. 1491. Errors of law as well as of fact may be corrected. Cf. Richardson v. Commissioner, 126 F. (2d) 462, 28 A.F.T.R. 1381. Here there was plain error in the 1934 return. The amendment was the plaintiff's only method to correct that error. And if the correction indirectly had the effect of improving plaintiff's tax position, that result was incidental only."[16]

[16] Other authorities permitting or requiring the filing of amended returns are: O.D. 111 (1919) Treasury Department, Cum. Bul. 1, p. 224; O.D. 113 (1919) Treasury Department, Cum. Bul. 1, p. 234; Mim. 2207 (1919) Treasury Department Cum. Bul. 1, p. 221; O.D. 1131 (1921) Treasury Department, Cum. Bul. 5, p. 289; T.D. 3220 (1921) Treasury Department, Cum. Bul. 5, 285; I.T. 2090 (1924) Treasury Department, Cum. Bul. III-2, p. 163; *U. S. v. Smith* (Dist. Ct. La., 1926), 13 F. (2d) 923, 5 A.F.T.R. 6116; *Levy v. U. S.* (C.C.A.-3, 1921), 271 F. 942, 2 A.F.T.R. 1368, in which a taxpayer was convicted of filing a false amended tax return; *Emmich v. U. S.* (C.C.A.-6, 1924), 298 F. 5, 4 A.F.T.R. 3917; *Lerner Stores Corp. v. Commissioner* (C.C.A.-2, 1941), 118 F. (2d) 455, 26 A.F.T.R. 711. See also *Zellerbach Paper Co. v. Helvering* (1934), 293 U. S. 172.

If the taxpayer's mistake had been one of deducting less depreciation than the amount allowable, the Government would proceed to reduce the base by the larger amount allowable. If it is equitable for the Government to do this, why should it not be equitable, as the legislature intended, that the same right be extended to the taxpayer especially where the original excessive deduction was taken by mistake and the correction of the mistake will not result in any loss of tax for the years in which the mistake was made, or in the loss of any legally computable tax for any year. The amended returns in this case represent the formal reporting of facts and errors which the taxpayer had for years been reporting to the Internal Revenue Agents and to the Commissioner of Internal Revenue. The amended returns are in effect conceded to be correct so consideration of the returns would have resulted in the concession of the appellant's contentions and the correction of errors made in the original returns. The Commissioner of Internal Revenue avoided this by treating the amended returns as though they had never been filed. We respectfully submit that this action of the Commissioner is improper and that the exorbitant tax levied by him against the appellant by reason of such action should not be countenanced or sustained.

V.

THE DISTRICT COURT ERRED IN REFUSING TO REOPEN THE CASE TO RECEIVE IN EVIDENCE THE LETTER RECEIVED BY APPELLANT FROM THE INTERNAL REVENUE AGENT IN CHARGE STATING THAT THE AMENDED RETURNS FOR THE YEARS 1932 AND 1933 HAD BEEN EXAMINED AND ACCEPTED AS CORRECT.

After the stipulations in this case were signed and filed with the District Court, an Internal Revenue Agent examined the amended returns filed for the years 1932 and 1933 and the appellant received a letter from the Internal Revenue Agent in Charge stating that the said returns had been examined and were found to be correct. Thereupon appellant filed a written motion with the District Court to reopen the case and receive the letter in evidence (R. 69). The Government opposed the motion on the ground that the matter was immaterial and in any event the examination and acceptance of the returns by the Internal Revenue Agent's office was all a mistake (R. 75). The Court denied the motion (R. 113).

Perhaps the letter was redundant because the stipulations in effect concede that the amended returns are correct and contain a correct statement of the depreciation deduction. But, if the Commissioner has any right to ignore the amended returns and his refusal to consider them should influence the ultimate outcome of this case to the detriment of the appellant, then the Court should have accepted the letter in evidence, to show that the amended returns were recognized and considered. True, the Commissioner asserts it was a mistake—but mistake or not he cannot deny the *fact* that the returns were examined and

accepted by his agents, and treat it as though it had never happened. Furthermore, his action in resisting this motion does not speak well for his position in this case. The stipulations establish that he recognizes that the appellant made a mistake in the original returns for the years 1932 to 1935, that the Government's interest with respect to the tax liability for those years would not be prejudiced by a correction of those returns, that the appellant has tried to be co-operative and to correct the mistakes and filed amended returns to formally correct those mistakes, and that the amended returns are correct, yet he has vigorously opposed every effort made by the appellant *and his own agents* to reach the right result. Why should he do this? Is he influenced solely by the fact that by maintaining that position he can exact a greater tax from the appellant in later years? There is nothing in the income tax law which prohibits him from accepting corrections or from examining the amended returns and accepting them. He knows that they are correct. Why does he persist in refusing to give them any consideration? His resistance to appellant's motion is an expression of fear that consideration of the returns would require concession of appellant's position. Why fear this? Appellant's position is equitable and just and should be conceded. The District Court found justification for the Commissioner's position by construing the *Virginian Hotel Corporation* case as requiring him to accept the original erroneous returns and to take the position that the acceptance of the returns is conclusive against the appellant as to the allowance of the excessive depre-

ciation taken thereon. It is respectfully submitted that this interpretation of that case is not a correct interpretation as hereinbefore argued. The Virginian Hotel Corporation decision says nothing about amended returns or the right or duty of the Commissioner to consider them; nor does it say anything which prohibits or forecloses the Commissioner from taking any steps to properly administer the income tax laws, to correct erroneous deductions, and to avoid the imposition against any taxpayer of any greater amount of tax than is legally due.

The Commissioner knew the amended returns were correct and should have accepted them and given effect to them even without further examination by his agents. But if his failure to consider them is any justification for his failure to give effect to them, then his position is destroyed by the consideration actually given them by his agents, and it is respectfully submitted that the District Court erred in failing to grant appellant's motion and to receive the acceptance letter in evidence, and to conclude therefrom that the amended returns should be considered effective as correcting the original erroneous returns; and since those returns were conceded to be correct the Commissioner had no legal authority to allow any other deduction for depreciation for the years 1932 to 1935 inclusive than the correct deductions reflected thereon.

CONCLUSION.

In conclusion it is respectfully submitted:

1. The *Virginian Hotel Corporation* case is not applicable to this case because the cases are distinguishable on their facts; or, if applicable at all, the case is controlling only on the proposition that the fact that no tax benefit was obtained from a depreciation deduction is not decisive of the question of whether or not the deduction was "allowed".

2. The District Court decision is wrong principally because the Court misconstrued the Supreme Court decision in the *Virginian Hotel Corporation* case as requiring the holding that the erroneous depreciation taken by appellant on its original returns for the years 1932 to 1935 could not be changed or corrected either by the appellant or the Commissioner. The Virginian Hotel Corporation decision is specifically limited to a situation where the depreciation taken in the earlier years was not challenged or objected to by the Commissioner or his agents, whereas in this case the agents of the Commissioner challenged the depreciation and corrected it. The limited issue in the *Virginian Hotel Corporation* case is entirely different from the principal issue in this case which relates to whether the Commissioner allowed the depreciation deduction aside from the application of the tax benefit rule. There is nothing in the Virginian Hotel Corporation decision which indicates that a depreciation deduction taken by a taxpayer on a return must be considered conclusively allowed even

though challenged and found by the Commissioner to be erroneous.

3. It is unjust and inequitable for the Government to refuse to permit appellant the right to restore to the unexhausted basis of its property the excessive depreciation erroneously and mistakenly reported on the original returns for the years 1932 to 1935, and to exact substantial taxes as the result of such refusal.

4. It was the intent of Congress that the statute should be so construed and administered as to accomplish just and equitable results, and not to permit the Commissioner to elect at the expense of the taxpayer whether he should comply with the income tax statutes in determining net income and whether he should allow the deduction authorized and prescribed by those statutes or some other deductions not authorized by those statutes.

5. It was improper for the Commissioner of Internal Revenue to close his eyes to the mistakes on the taxpayer's tax returns for the years 1932 to 1935 and to deny to the taxpayer, by refusing to consider or act upon the amended returns filed by it, the right to correct those mistakes.

6. The depreciation deductions taken by the taxpayer on its original returns for the years 1932 to 1935 were so flagrantly wrong that they were not allowable under the income tax laws and could not be allowed by the Commissioner, especially when (1) the returns themselves indicated that the deductions exceeded the depreciation charged off on the books,

(2) the taxpayer admitted the deductions to be wrong, (3) the Internal Revenue Agents challenged the deductions and corrected them, and (4) no just tax would be lost by the correction of the deductions.

7. The Commissioner has authority to allow only such deductions as are reasonably allowable under the statute, and the only depreciation reasonably allowable under the income tax laws for the years 1932 to 1935, inclusive, is the depreciation repoted by the taxpayer on the amended tax returns for those years and computed by the Internal Revenue Agents and engineers in their detailed schedules correcting the depreciation. Where the Commissioner became aware of the facts showing the depreciation to be erroneous he had no authority to allow it, and he was under legal obligation to allow only the amount allowable under the statute. His refusal to accept the revised depreciation schedule which he knew to be correct, and his insistence in allowing a deduction which he knew to be wrong, cannot constitute a legal allowance under applicable income tax laws.

8. The cost basis of the depreciable assets as of December 31, 1935, should be reduced only by the depreciation stipulated in this proceeding herein as the correct depreciation for the years 1932 to 1935, inclusive and reported on the amended returns for the years 1932 to 1935, inclusive.

If the Court should decide that the Government and the District Court are correct in refusing to restore to the base as of December 31, 1935, any of the

excessive depreciation taken on the original returns for the years 1932 to 1935, then the judgment below should be sustained. (Stip. 2, ¶ 27(b).) If the Court should decide that the base should be the amount claimed by the taxpayer or some other amount greater than that allowed by the Government, the amount of the tax recovery to which appellant is entitled can be computed by the parties after the decision is rendered.

The facts, the law, and the equities justify a decision in favor of the appellant and it is respectfully urged therefore that the Court reverse the decision of the District Court on the issues here involved.

Dated, San Francisco, California,
March 8, 1948.

Respectfully submitted,
George H. Koster,
Counsel for Appellant.

(Appendix Follows.)

Appendix.

Appendix

DISCUSSION OF THE CASE OF THE VIRGINIAN HOTEL CORPORATION OF LYNCHBURG.

Introduction.

The District Court sustained the contention of the Commissioner of Internal Revenue that the identical question involved in this proceeding was decided by the United States Supreme Court in the case of *Virginian Hotel Corporation of Lynchburg v. Helvering,* decided June 7, 1943, with four Justices dissenting, 63 S. Ct. 1260, 319 U. S. 523, 30 A.F.T.R. 1304, and that his determination is in accord with that decision.

The Supreme Court did construe to a certain extent the statutory provisions here involved. It decided that in determining the unexhausted basis for depreciation, the cost must be reduced by the depreciation "allowed" in prior years even though no tax benefit was obtained from that allowance, a point not contested in this proceeding. That case went to the Supreme Court on an entirely different set of facts than is involved in this case with attention directed primarily on the question of whether depreciation is "allowed" if it did not result in a tax benefit in the year deducted, and to the fact that neither the Commissioner nor his agents had ever challenged or objected to the depreciation deducted in the prior years.

We concede that the *Virginian Hotel Corporation* case is conclusive on the point that a depreciation deduction may have been "allowed" even though no

tax benefit was derived therefrom but the matter of principal concern in this case is the question of the amount of depreciation, if any, actually or legally "allowed" for the years 1932 to 1935, apart from whether a tax benefit was obtained, and there was no such question in issue in the *Virginian Hotel Corporation* case.

Conceded applicability of the Virginian Hotel Corporation case.

In the instant case the appellant bank had large net losses for 1930 and 1931, far in excess of the depreciation deduction for those years so it obtained no tax benefit from those deductions. The depreciation for those years was based upon the conditions which the Bank in its judgment then believed existed as to the useful lives of the property. It is true that the Bank's survey of its property in 1932 proved that its judgment in the prior years was erroneous, based upon the subsequently discovered data, but that in no wise detracts from the fact that based upon what it knew in 1930 and 1931, its judgment in its depreciation claim for those years was correct. This is the type of situation to which we believe the *Virginian Hotel Corporation* case is applicable, to prevent the taxpayer from changing its depreciation *based upon after-discovered information* where the depreciation was properly allowed on the basis of conditions known to exist at the time the depreciation was claimed. It is because of our conviction that this is the proper interpretation of the *Virginian Hotel Corporation* case that we have *not* made claim for restoration of any depreciation deducted for the years 1930 and

1931. (See *Commissioner v. Mutual Fertilizer Co.* (C.C.A. 5, 1947, 159 F. (2d) 470); *Com. v. Cleveland Adolph Mayer Realty Corp.* (C.C.A. 6, 1947, 160 F. (2d) 1012). But the circumstances with respect to the depreciation for the years 1932 to 1935, as established by the stipulation, are entirely different than for the years 1930 and 1931.

In order to illustrate the basis of our conviction as to the applicability of the *Virginian Hotel Corporation* case, the history of the litigation in that case is important.

History of litigation in the case.

The case was first decided by the United States Board of Tax Appeals (now the Tax Court of the United States) in favor of the taxpayer on May 6, 1942. The decision was reported as a memorandum decision, Docket No. 105828. The Board stated the facts to be as follows:

The taxpayer had claimed depreciation at consistent rates from 1927 to 1938. The Commissioner of Internal Revenue did not question the depreciation deduction claimed in the years 1927 to 1937. The taxpayer had net losses in the years 1931 to 1936. The Commissioner, when auditing the 1938 return, determined that the depreciation rates were excessive and he applied revised rates on the unexhausted base of the property as of December 31, 1937, to compute the depreciation deduction for 1938.

The Board stated the issue to be whether the taxpayer is entitled to restore to its unexhausted base

of depreciable assets on December 31, 1937, the amount of $31,400.25 due to a change in rates of depreciation by the Commissioner. The $31,400.25 was the excess of the depreciation deducted on the returns from 1931 to 1936 over the lower depreciation which would have been computed for those years if the revised depreciation rates determined by the Commissioner for the year 1938 had been used. No tax benefit had been obtained by the taxpayer from the deduction of this excessive depreciation because the taxpayer had reported net losses for those years.

The Board decided in the taxpayer's favor solely on the ground that depreciation is not "allowed" within the meaning of the Revenue Acts unless it is actually taken as a deduction against taxable income and therefore, to the extent the taxpayer received no tax advantage in the loss years, the depreciation for those years should be computed by employing the lower rates determined by the Commissioner instead of the rates used by the taxpayer. The Board concluded that the excess of the depreciation deductions taken in the loss years, over the amounts allowable (using the Commissioner's revised rates) should be added to the base in computing the depreciation allowable for 1938.

In view of the fact that the decision of the Board was in favor of the taxpayer on a broad legal ground, there was no indication in the decision whether at the time the taxpayer took the deductions in the loss years, the deductions were not proper in accordance with the then known facts. It is clear in the findings

that the Commissioner did not question the deduction claimed in each year from 1927 to 1937 and this, we think, to be significant because in many of these years the taxpayer had taxable income and received a benefit from the deduction.

The Government appealed and the Board was reversed by the U. S. Circuit Court of Appeals for the Fourth Circuit in a decision rendered January 2, 1943; *Helvering v. Virginian Hotel Corporation of Lynchburg,* 132 F. (2d) 909, 30 A.F.T.R. 700:

The Circuit Court stated the question as follows:

> "The question involved relates to the right of a taxpayer to add to the depreciation base, on a change of the rate of depreciation, amounts charged off and allowed as depreciation in prior years, where no tax benefit has been received as a result of such allowance. The contention of the taxpayer is that the new rate of depreciation should be applied retroactively, and that the excess depreciation charged off and deducted under the old rate should be restored to the base, when it appears that the taxpayer has received no tax benefit from the deduction. The Board sustained this contention and the Commissioner has asked that its decision be reviewed, contending that there is no authority for restoring to the base the depreciation which has been claimed and allowed, and that whether tax benefit has resulted from the allowance or not does not affect the matter."

The Court thought the Board to be in error, stating:

> "There is nothing in the statute, or elsewhere, which justifies restoring to the base the deprecia-

> tion which has been claimed and allowed in prior returns, *merely because* such allowance has resulted in no tax benefit." (Italics ours.)

It would appear from these quotations that the Court was considering the case solely from the point of view of whether a tax benefit or lack of it should have any bearing on the question of whether a deduction had been allowed, and that the Court was not inquiring otherwise into the propriety of the allowance.

The Court quoted with approval the dissenting opinion of Board Member Disney in the *Kennedy Laundry Company* case, 46 B.T.A. 70, relating to the Congressional intent in providing in the Revenue Act of 1932 that basis for depreciation shall be the basis adjusted for depreciation "to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws". Part of the Court's quotation from Member Disney's opinion was:

> "It seems to me that Congress in 1932, as it did in 1924, used the word 'allowed' in order 'to remove a possible ambiguity', that is, intended in order to make the matter definite, to say that if a depreciation item was 'allowed' in the sense that a claim therefor was not opposed or the depreciation was given effect in determining the tax situation for the year involved, it was to constitute a ground for adjustment of base for the property considered. I think that was all that Congress had in mind and that the legislators did not go into more tenuous consideration of tax advantage, or lack thereof in the year of

depreciation, but laid down a definite and not unfair rule. The taxpayer had the opportunity of preventing the 'allowance' of more depreciation than necessary (above the 'amount allowable' or reasonable amount). *He could limit his claim, withdraw it to any extent desired, or oppose its use by the Commissioner. This being within his power, there is no injustice in requiring him, when property basis is considered in later years, to abide by the figure used by him, or permitted by him to be used.*" (Italics ours.)

The Court, after giving this quotation, continues with this statement:

> "There was no intention to authorize retroactive adjustments. With respect to this, the report of the Senate Committee referred to above had the following to say: 'Your committee has not thought it necessary to include any express provision against retroactive adjustments of depreciation on the part of the Treasury as the regulations of the Treasury seem adequate *to protect the interests of the taxpayers in such cases. These regulations require the depreciation allowances to be made from year to year in accordance with the then known facts and do not permit a retroactive change in these allowances by reason of the facts developed or ascertained after the years for which such allowances are made*'." (All italics ours.)

The Court then concluded that the Commissioner's method of computing the depreciation for the year 1938 was proper, and that the basis for depreciation should not be increased by any part of the depreciation deducted in the loss years.

The Court seemed to base its opinion principally on the ground that the fact that the taxpayer had not obtained a tax benefit from the deduction was irrelevant to the issue as to whether the basis had to be adjusted for the depreciation "allowed". The Court does not mention any question as to whether the depreciation for the earlier years had been "allowed" or properly "allowed", but it would apear from the Court's quotation of the Senate Committee report that the depreciation allowance is to be made from year to year in accordance with the then known facts, and from the Headnote 2 in the official report of the case, reading as follows: "Where hotel established depreciation schedule *based upon an estimated useful life* of property and *subsequently estimated* useful life was fixed at a longer period, hotel was not allowed to add to new depreciation base excess amounts previously charged off and allowed as depreciation notwithstanding that no tax benefits had been received as a result of such allowances", and from the fact that the Court made no conclusion either way as to whether the amount actually allowed exceeded the amount allowable under the facts known at the time, that the Court purposely avoided a conclusion that the amount allowed was in excess of the amount allowable for the respective years. We believe it significant too that the Court qouted that portion of Member Disney's opinion to the effect that the taxpayer had the opportunity to "limit his claim, withdraw it to any extent desired, or oppose its use by the Commissioner" because there is nothing in the case which indicated that there had ever been any reason prior to

the time the Commissioner audited the 1938 return to question the depreciation taken by the taxpayer in years prior to the year 1938.

The taxpayer appealed the case to the United States Supreme Court who granted certiorari because of a conflict between this case and the *Pittsburg Brewing Company v. Commissioner* case, 107 F. (2d) 155, decided by the Circuit Court of Appeals for the Third Circuit, in which case the Court decided that depreciation claimed in excess of the amount legally allowable is not "allowed" unless taxable income is offset thereby, and here again there was no other question as to the propriety of or the actuality of the allowance. The decision of the Supreme Court in the *Virginian Hotel Corporation* case, rendered June 7, 1943, is reported in 63 S. Ct. 1260, 319 U.S. 523, 30 A.F.T.R. 1304.

The Supreme Court decided the case squarely on the issue of whether the basis would have to be reduced by the excess of depreciation deducted and allowed over the amount properly deductible where the excess deduction did not serve to reduce taxable income in the years the deductions were taken, and held that the base must be reduced by the depreciation allowed regardless of whether the allowed deduction resulted in a tax benefit.

The Court did say that the use of the word "allowed" in the statute involved in the case, "plainly has the effect of requiring a reduction of the depreciation basis by an amount which is in excess of depreciation properly deductible". The Court also stated

that deductions not challenged by the Commissioner of Internal Revenue are "allowed". In its statement of the facts the Court pointed out that "No objection was taken by the Commissioner or his agents to the amounts claimed and deducted". With respect to the interpretation of the statute, the Court stated:

> "The requirement that the basis should be adjusted for depreciation 'to the extent allowed (but not less than the amount allowable)' first appeared in the Revenue Act of 1932. Prior to that time the adjustment required was for the amount of depreciation 'allowable'. The purpose of the amendment in 1932 was to make sure that taxpayers who had made excessive deductions in one year could not reduce the depreciation basis by the lesser amount of depreciation which was 'allowable'. If they could, then the government might be barred from collecting additional taxes which would have been payable had the lower rate been used originally.* But we find no suggestion that 'allowed' as distinguished from 'allowable' depreciation is confined to those deductions which

*S. Rep. No. 665, 72d Cong., 1st Sess., p. 29: "The Treasury has frequently encountered cases where a taxpayer, who has taken and has been allowed depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact 'allowable' were much less. By this time the Government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's present contentions. The Treasury is obliged to rely very largely upon the good faith and judgment of the taxpayer in the determination of the allowances for depreciation, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayer, and the Treasury should not be penalized for having approved the taxpayer's deductions. While the committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility."

result in tax benefits. 'Allowed' connotes a grant. Under our federal tax system there is no machinery for formal allowances of deductions from gross income. Deductions stand if the Commissioner takes no steps to challenge them. Income tax returns entail numerous deductions. If the deductions are not challenged, they certainly are 'allowed' since tax liability is then determined on the basis of the returns. Apart from contested cases, that is indeed the only way in which deductions are 'allowed'. And when all deductions are treated alike by the taxpayer and by the Commissioner, it is difficult to see why some items may be said to be 'allowed' and others not 'allowed'. It would take clear and compelling indications for us to conclude that 'allowed' as used in Section 113 (b) (1) (B) means something different than it does in the general setting of the revenue acts."

Four Justices dissented from the majority opinion.

Distinguishing features between Virginian Hotel Corporation case and this case.

It is clear that *at no time* did the Commissioner of Internal Revenue *or his agents* challenge the depreciation taken by the Virginian Hotel Corporation for years prior to 1938. In that respect this case is distinguishable from the instant case since the record shows quite clearly that the Commissioner's agents not only challenged the Bank's depreciation for the years 1932 to 1935, but also corrected it. It is also clear, so it seems to us, that there was no question that the deductions taken by the Virginian Hotel Corporation for years prior to 1938 were correct, based upon conditions known at the time the depreciation

was deducted and it was only the subsequently made estimate which indicated that the rates taken by the taxpayer were excessive. In that respect the case is distinguishable from the instant case since the record shows that the depreciation taken on the original returns was definitely wrong on the basis of conditions then known to the Bank and then reflected on its books.

It is also clear that the attention of the Courts in the *Virginian Hotel Corporation* case was directed exclusively to the question of whether a tax benefit from a depreciation deduction, or lack of it, should alone determine the question of whether the deduction was "allowed" under the statute. The Supreme Court, in answering that question, assumed that the depreciation "allowed" in the prior years exceeded the amount "allowable" but actually the factual basis presented the question not specifically discussed, because of the limited issue present in the case, of whether a revised depreciation based upon subsequently made estimates could be claimed by the taxpayer to be "allowable" depreciation, as against the amount actually deducted based upon the conditions known at the time the deduction was taken, and we cannot be certain whether the Supreme Court was nevertheless influenced by this circumstance.

While the contention as to the effect of a lack of tax benefit from the deduction was the only contention considered in the *Virginian Hotel Corporation* case, that contention is merely an incidental one in this case. The principal issue in this case is whether under the many other facts (the like of which were not

present in the *Virginian Hotel* case) the depreciation deductions taken in the original returns for 1932 to 1935 were allowed at all, or if allowed, whether they were properly allowed.

It is clear that the Supreme Court merely assumed that when a deduction is taken on a return and not challenged, it is allowed. It is significant and important to note that the Court made this assumption upon the qualifying condition that the depreciation had not been challenged by the Commissioner or his agents, because the existence of that condition makes it unnecessary to question whether the Court would have made the same assumption if it had had before it some evidence of the procedure actually followed in handling tax returns. The Court was not called upon to decide what constitutes an allowance where the deduction is challenged, and was not in a position to decide that point because there was no evidence before the Court as to the machinery for allowances of deductions, or the office practices under which errors might be discovered or deductions challenged and under which corrections might be merely deferred, or the errors tolerated because no tax would result from the corrections. Nor was there evidence that a deduction might be challenged long after the return was accepted and that actually the deductions for any taxable year are subject to challenge and disallowance, even after the return is accepted, so long as the statute of limitations has not barred the assessment of tax for that year *or for any later year* as to which additional tax might result from the disallowance. In the instant case the record is replete with

evidence that if there is any allowance at all of a deduction otherwise than in a contested or thoroughly investigated case, there is no certainty of allowance until by lapse of time and the bar of the Statute of Limitations there is absolutely no possibility of a tax liability for any year from the disallowance of the deduction (R. 30, Stip. ¶ 6a). The record shows that in a loss year a challenged deduction may be found to be erroneous by the Commissioner or his agents and yet may not be changed because of the Commissioner's rule that where no tax would result from the correction, no time should be spent by the agents to make the correction. Even if the Commissioner should make a change, there is no procedure which provides for informing the taxpayer of such change if no tax resulted therefrom (R. 30, ¶ 6). The Supreme Court might very well have had in mind the possibility of just such a situation as exists in this case and therefore specifically limited its decision to avoid its application to a case such as this one where the deduction was challenged.

There is nothing in the *Virginian Hotel* case to show that the taxpayer ever made any effort, other than in that particular litigation to correct the depreciation for the prior years. In that respect that case is distinguishable from the instant case since in this case the Bank tried for nine years to obtain the correction of errors which might be attributable to the negligence or mistake of its employees in failing to take the proper depreciation deductions in the years 1932 to 1935, actually did obtain a correction of the deductions by the government agents, and then filed amended returns correcting the deductions after

the Commissioner of Internal Revenue rejected the work of his agents.

It is respectfully submitted that although there is a similarity of the ultimate issues in the *Virginian Hotel* case and this case, the cases are so different factually that the *Virginian Hotel* case cannot be considered applicable as determinative of this case. The principle pronounced in that case, that a depreciation deduction may be "allowed" even though no tax benefit was derived therefrom is applicable but since that point is here conceded and is not relied upon to establish appellant's contentions which relate to whether the excessive deduction was or could be allowed, that case is of no further applicability.

This case involves essentially the effect to be given to a particular set of facts. One instance alone, the fact that in this case the government agents challenged the depreciation deductions taken in 1932 to 1935 and corrected them whereas in the *Virginian Hotel* case there was no challenge of the deductions, would justify either a conclusion contrary to the *Virginian Hotel* decision, or a conclusion that the *Virginian Hotel* case was distinguishable on the facts and therefore inapplicable.

The *Virginian Hotel* case contains no answer to whether under the facts in this case the Commissioner of Internal Revenue had any right to "allow" the depreciation deducted by the Bank on its original returns for the years 1932 to 1935, or whether he did allow it, or whether he had any right to refuse and reject the Bank's efforts to correct those original returns and the depreciation claimed thereon.